Current Financial Accounting Research

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What would you say it is that you do here?
Well, I teach financial accounting
But I also do research

- Accounting and security prices
- Earnings management / Accounting fraud / litigation
- Current standard setting issues
Recent research you may find interesting

- Fair value accounting in the banking industry
  - Did fair value write downs exacerbate the financial crisis?
  - Are fair values “better” than historical costs?

- Rules-based vs principles-based accounting standards and their effect on litigation and enforcement

- Did SOX-era governance reform work in reducing accounting fraud?
Did fair value accounting contribute to the financial crisis?

- Some claim that fair value accounting exacerbated the financial crisis and led to “pro-cyclicality”
- Is this true? Is there any systematic empirical evidence on this issue?
Fair value and pro-cyclicality

- Sales of risky assets
- Decline in market prices
- Low capital ratios
- Fair value write downs
Findings

- **Bhat, Frankel, and Martin (2011)**
  - Positive link between asset sales/purchases and MBS prices
  - Link is attenuated after April 2009 mark to market rules

- **Badertscher, Burks, and Easton (2012)**
  - Most fair value write-downs did not affect regulatory capital
  - No evidence of systematic increase in securities sales during the crisis
Takeaway

Although fair value accounting may have had some pro-cyclical effect during the crisis, it does not appear to be economically significant.
Is fair value for financial instruments more useful to users than historical cost?

- Depends
- For securities, the answer appears to “yes” in most cases
  - Stock price evidence
  - Evans, Hodder, Hopkins (2011)
- What about more illiquid financial instruments, like loans?
  - Stock price evidence
  - Cantrell, McInnis, Yust (2012) [CMY]
We investigate whether bank loans measured as fair value or net historical cost better predict future credit losses:

- Chargeoffs
- Non-performing loans
- Bank failures

Our tests indicate net historical costs generally do a better job

Why?
Takeaway

- Net historical cost accounting for loans appears to be more useful in assessing credit risk than fair values as currently reported.
- Standard setting implications.
Rules vs principles-based accounting standards

- Do detailed rules-based standards increase or decrease litigation risk?
  - Donelson, McInnis, and Mergenthaler (2012)
- Examine all class action securities litigation from 1996 to 2005
- Classify standards in GAAP as more or less rules-based
  - Bright line thresholds
  - Scope or legacy exceptions
  - Excessive detail
  - Excessive implementation guidance
What we find

- In cases where firms do not admit to a mistake (no restatement), plaintiffs tend to target principles-based areas of GAAP.
- In cases where firms do admit to a mistake (via a restatement), plaintiffs tend to target the principles-based restatements.
- Takeaway: rules-based standards appear to decrease litigation risk.
Sox-era governance reforms

- Do more independent boards and audit committees reduce the risk of accounting fraud?
- Does providing non-audit services to audit clients increase the risk of accounting fraud?
- Difficult to infer causation from cross-sectional association studies
In response to accounting frauds, Congress (via SOX) and the exchanges mandated increases to board independence, audit committee independence, and banned most non-audit services to audit clients.

“Natural” experiment

Did forcing firms to do this reduce the risk of accounting fraud?
Findings

- Firms forced to increase board independence did experience a drop in the rate of accounting fraud
  - About 2.8 percentage points
- Firms forced to adopt a fully independent audit committee did experience a drop in the rate of accounting fraud
  - About 2 percentage points
  - However, when examined jointly, only the increase in full board independence matters
- Firms forced to give up non-audit services from their auditor experienced no change in the rate of fraud
Takeaway

- The SOX-era governance reforms had some of their intended effect
Thank you for your time!

- Questions?
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