Disclosures and Judgment in Financial Reporting: Essays on Accounting Quality Under International Financial Reporting Standards

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To Mom and Dad

Abstract

As capital markets become more integrated and globalized, standard setting in financial accounting faces multiple challenges. Financial accounting standards must adapt and change in ways that make them usable to firms in varying institutional and economic settings, and by extension, make the financial statements produced under those standards useful to capital market participants worldwide. A question that arises is how to ensure corporate transparency and faithfully represented financial reports, and whether principles-based—rather than rules-based—standards are superior in this context. Two areas of particular interest to standard setters are mandatory disclosures made within the scope of the standards, and judgments and estimates required by financial statement preparers when standards are predominantly principles-based.

This thesis investigates quality implications of features pertaining to three different accounting standards: IAS 1 *Presentation of Financial Statements*, IAS 19 *Employee Benefits* and IFRS 9 *Financial Instruments*. The underlying aim is to draw conclusions about effects on accounting usefulness of the various accounting methods and disclosure and recognition rules prescribed by these standards. The rationale for this type of research can be derived from the IASB's own requirements that a post-implementation review (PIR) be executed whenever significant financial reporting changes are introduced by a new or revised standard.

The studies carried out within the scope of this thesis show that in accounting for certain discretionary items related to employee benefits, there appears to be improvements in transparency as firms are required by the amended IAS 19 to move previously off-balance-sheet items onto the balance sheet, thus formally recognizing them rather than merely disclosing them in the supplementary notes. Further, evidence on disclosures made in accordance with IAS 1 points to comparability issues and to the disclosures being of varying quality, with accounting outcomes being contingent on the individual firm's contextual factors. This indicates that the principles-based disclosure standards that are currently favored by standard setters do not work as well as expected. Meanwhile, as regards estimation of credit losses in banks, there is evidence to support the current move towards a more principles-based standard (IFRS 9), provided that there is enforcement of adequate quality.

Key words: *Accounting quality, Judgment, Disclosure, Principles-based Accounting, Employee Benefits, Credit losses*

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Opus consummavi! Thank God! (I mean that in a highly figurative sense and prefer not get too technical about the role of God in all of this—neither do I desire here to make an expedition outside the realm of empiricism, nor can I claim this text is divinely inspired.) I have finally reached the point where one particular curvilinear line comes to an end and where there is nothing left to do but breathe a long sigh of relief and take a bow before all those people who have helped me get to said point. I shall proceed chronologically.

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To all of you out there, holding this text: happy reading!

Emmeli Runesson,

Göteborg, January, 2015

Contents

Introduction

1

Overview and background

1.1 General background

'Financial accounting? Really? Can you do research in that? Isn't it like ... just debit-credit, right and wrong?' Receiving this type of response is surprisingly common when one admits to one's type of work; it may in some ways even be considered a kind of occupational hazard. Because what is financial reporting good for anyway? What is *research* in the area good for? Does it save lives? Does it at least promote innovation and new technologies? Does it raise our standard of living?

A more general question is to ask what the purpose of research is in broader terms. A sensible suggestion is that it should make people's lives better. This requires us to define 'better', in this case within the field of financial accounting; this, in turn, requires us to set up an objective function (normally this is done within the sphere of politics, and not by researchers themselves). Reasonable aims within economics and business research involve economic growth, income distribution or equality, and ways of dealing with sustainability goals and environmental impact. A prominent stream of research in accounting has perhaps focused primarily on the first of these, that is, growth.

Ideally, efficient allocation of capital will lead to higher growth (and ultimately greater world wealth—a perhaps fanciful but undeniably worthy objective). What has been long argued by accounting researchers, is that for the capital markets to work efficiently, those who have capital need information about the different investment options available to them, in order to make informed decisions. Arguably, this is where accounting fits in—if it is of adequate quality, it will contribute to well-functioning capital markets.

Whereas preparers of accounting information can be any type of organization or corporation (typically listed limited liability companies are the focus in research

due to the relatively large amount of information emanating from these and due to them being of significant public interest), the above-stated objective labels capital providers as the main users of financial reporting. Other commonly recognized recipients include tax authorities, employees and suppliers, and other types of decision-makers, but it is arguably investors, and to a certain extent creditors, that have received the greatest attention from financial accounting researchers (especially in the US but, recently, also internationally). These capital providers, represented by investment funds as well as private investors and bond holders, but also intermediaries such as analysts, act on the equity and debt capital markets. The idea behind these types of markets is indeed to allocate capital to those sectors that give the highest return on the invested capital, that is, where it is of greatest use.

Research can contribute by showing how one should act *given* certain objectives. Therefore, in accounting, focus has—among other things—been on the characteristics and behavior of preparers and users of accounting, on the regulatory setting (including standard setting and enforcement) as well as on the information or accounts themselves. One is interested in identifying that which determines what information is provided, as well as evaluating the usefulness of said information. Often the questions are implied: 'Which types of firms provide more useful information?', 'What do users think *is* useful information?', 'Which standards and enforcement schemes produce more useful information?' and 'What do useful accounts contain?'

The essays in the book you are currently holding in your hand are all based on the premises described above. They exist within a paradigm where questions of interest all concern the idea of *high-quality accounting*: what characterizes it, and what are the determinants and consequences of high-quality accounting? The term *accounting* refers to regulated financial statements (comprising the balance sheet, income statement, statement of owner's equity, cash flow statement and supplementary notes), as well as additional accounting disclosures made voluntarily; meanwhile, *high-quality* refers here to accounting that provides capital market users with useful information (and hence, in the end, improves capital allocation). These broad definitions are derived from the discourse set by the world's biggest standard setters in accounting, the US Financial Accounting Standards Board (FASB) and the supra-national International Accounting Standards Board (IASB). They claim implicitly and explicitly that accounting usefulness is achieved when capital market participants find accounting to be relevant for decision-making, which in turn requires the numbers to be faithfully represented (reliable). These are of course broad definitions, but each essay presented here can be linked to a particular feature of accounting quality.

Accounting standards as a quality determinant is perhaps where most of the focus lies in this book, not least due to the importance that I assign differ-

ent aspects of regulation—particularly the International Financial Reporting Standards (IFRS)—in the context of accounting outcomes. Many aspects of IFRS have been studied in the literature, not least compliance and *de facto* harmonization of what aims to be a global set of standards. I home in on the principles-based nature of the standards, the role that preparers' judgment is allegedly allowed to play in the production of financial reporting, as well as on the role of disclosures. Other determinants, however, are also taken into account, sometimes being the explicit focus. For example, the institutional environment, including enforcement on a national or supra-national level, has repeatedly been shown to matter in shaping what accounting looks like. I acknowledge that corporate governance and other internal control mechanisms (including audit quality) constitute closely related quality determinants; these, however, remain on the sidelines in the essays presented here. Finally, firm-specific incentives have been much discussed in the literature, and are considered throughout this text.

1.2 The essays

Before proceeding, the reader will benefit from being familiar with the three essays that make up the bulk of this book, and the main issues discussed and studied in these. They are therefore summarized below.

Essay 1: Determinants of principles-based mandatory disclosures

In this essay, we investigate principles-based mandatory disclosures, which are characterized by less exact guidance and fewer bright-line rules. More specifically, we evaluate how they work in practice by studying firm compliance with requirements in IAS 1 *Presentation of Financial Statements*, paragraphs 122 and 125. Ideally, if the disclosures are of high-quality, they should reflect the firm's underlying economics, which, in the case at hand, is equivalent to measurement uncertainty and estimation complexity. If, on the other hand, a firm's propensity to disclose and the level of disclosure are largely explained by other factors, such as firm-specific incentives, enforcement and other contextual factors, the usefulness of the disclosures decreases and may be questioned. If the standard is inconsistently applied, the disclosures will be less comparable between firms and thus reflect implementation issues of IFRS raised in prior literature. This study is timely in the light of the ongoing debate on the role of disclosures and what shape they should take, along with discussions of the merits of principles-based accounting and recent updates to IAS 1 under the IASB's current Disclosure Initiative.

Essay 2: From disclosure to recognition: The case of 'corridor' accounting under IAS 19 Employee Benefits

This study belongs to a research area that is concerned with the differences between disclosures in the notes and recognized items in the primary financial statements. The source of observed differences has not been established, although it has been suggested in prior literature that disclosures in the notes have lower reliability than recognized items and that disclosed amounts may not be factored into leverage ratios and therefore have a differential effect on debt contracts. Moreover, it has been shown that presentation format can affect the usefulness of information to investors; if disclosures are considered more complex or less complete, and therefore less readily accessible to users, this would lower their usefulness and prevent disclosed amounts from being impounded in market prices. I examine three market events related to the development and implementation of the 2011 amendments to IAS 19 *Employee Benefits*, which mandates recognition of previously disclosed amounts. The study sheds light on the market effects of the standard change in question, but also addresses the broader issue of disclosure-versus-recognition described above.

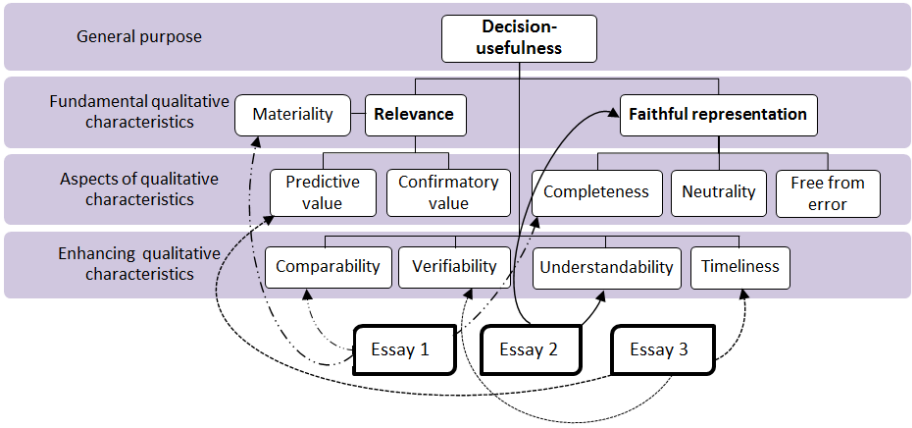
Essay 3: The effect of accounting standards on loan loss provisioning in banks

In Essay 3, we inquire into whether a high-judgment approach is superior to a low-judgment approach when making provisions for credit losses in banks. Just as in Essay 1, estimation uncertainty is one of the focal points. By accepting somewhat higher uncertainty through the use of more judgment, the firm (bank) is allegedly able to convey private information to the market in a more timely manner. The current IFRS standard is used as a proxy for *less* judgment, where the loss event is required to be 'incurred' and thus verified, whereas local GAAP serves as a proxy for more judgment (as losses may just be expected or estimated). This study is highly relevant at a time when the EU is considering adopting IFRS 9 *Financial Instruments*, in which the 'expected loss' model replaces the 'incurred loss' model prescribed in the previous standard on financial instruments (IAS 39). Whether country-level enforcement and firm-level incentives further affect outcome, is also investigated.

What these essays all have in common is their assumption that accounting has an *information role*; more specifically, financial accounting is a tool for individuals outside the firm to help improve their decision-making. Which information produces higher-quality accounting, and how that information should be structured, are questions that are relevant under the information role of accounting. Figure I shows schematically the aspects of the IASB's Conceptual Framework that are concerned with decision-usefulness.[1]

[1]The Conceptual Framework is the 'constitution' of the IASB, if you like; it spells out the overarching principles that ought to guide the preparation of financial reports. It should be noted that the other main standard setter in the world, FASB, shares this framework in

Figure I
The IASB's Conceptual Framework



The framework not only specifies that the main intended user of the financial reports are capital providers and that the general purpose of the reports therefore relate to how useful that information is for their decision-making; the various qualitative characteristics the financial accounts should exhibit are also specified. The fundamental qualities are *relevance* and *faithful representation*, where relevance refers to information that is material and has predictive and/or confirmatory properties in relation to actual outcomes. Faithfully represented information, meanwhile, is that which is complete, neutral and free from error. Other features enhancing the decision-usefulness of the financial reports are comparability, verifiability, understandability and timeliness. Given the above specifications, it seems reasonable to evaluate the usefulness of the information in relation to said characteristics. The essays can be shown to address usefulness in a variety of ways and in relation to these characteristics. Essay 1 focuses on comparability and relevance in terms of materiality, but also on completeness. IAS 1 disclosures, in order to be useful and comparable, should reflect estimation uncertainty in material items, should be complete, and should not be driven by factors not related to the underlying economic reality of the firm. Essay 2 focuses on different aspects of faithful representation ('reliability' in the previous Conceptual Framework) by considering investor reactions to standard changes that potentially affect the completeness, presence of errors and neutrality of the provided information about certain pension-related items. Also, the understandability of these amounts is believed to be affected by moving these items onto the balance sheet. Essay 3, in evaluating the loan loss provisioning models, is concerned with the timeliness, verifiability and predictive value of these provisions.

essence, if not always in the exact wording.

Table I
Summary of essays, research questions and accounting issues

Essay	Research question	Implied accounting quality issue
1	What factors determine principles-based mandatory disclosures?	How useful are the IAS 1 disclosures to the market, given the factors that drive them? Should principles-based disclosures be widely used?
2	How do investors react to the amendments to IAS 19?	Are formally recognized items more informative to the market than disclosures in supplementary notes? Does the new IAS 19 improve accounting transparency, by increasing the reliability, completeness and understandability of the information?
3	Is the 'expected loss' model superior to the 'incurred loss' model when it comes to the predictive ability of loan loss provisions?	Should standards that regulate loan loss accounting (here: IFRS 9) allow more judgment and what are the quality implications of this? What role do incentives and enforcement play in this setting?

In addressing said aspects of accounting quality, the accounting standards themselves, country- and firm-level factors, as well as preparers' incentives, are posited as main quality determinants. Table I summarizes the research questions and implied issues in each essay. With respect to the user perspective in each essay, the questions and issues of Essay 1 are thought to be relevant to equity- as well as debt-capital providers, while Essay 2 takes mostly an investor perspective and Essay 3 mostly a creditor perspective.

Finally, Healy and Palepu (2001) outline four research areas in particular as regards corporate disclosures. Extending this to accounting information in general, they may be expressed in terms of how accounting

1) ...should be shaped—or not be shaped—by *regulation*,
2) ...is affected by *managers' reporting incentives*,
3) ...has *consequences for the capital market*, and
4) ...interacts with *auditors and analysts (intermediaries)*.

It is within this context that I hope to make a contribution with the present essays. In studying how firms account for or disclose a particular financial item, Essays 1–3 can make implicit normative statements as regards standard-setting and the relative usefulness of stipulated or chosen accounting methods. More specifically, all the essays deal with the first point as they focus on different aspects of IFRS (IAS 1, IAS 19 and IAS 39/IFRS 9, respectively). Essay 1 and 3 also deal with the second point, as they highlight how incentives and judgment affect accounting quality. Essay 2 is concerned with the third point, in showing market reactions to a change in IAS 19. Admittedly, the last point is for the most part touched upon only indirectly, although the role of enforce-

ment, beyond firm-level audits and analyst following, can contribute to our understanding of the financial reporting environment and its determinants and outcomes.

What I have set out to do here and in the following chapters that lead up to the three essays presented in the latter part of this book, is introduce related prior research and, in so doing, attempt to exposit the links between the essays and their common themes. I discuss, in turn, evidence on capital market effects of accounting (Chapter 2), regulatory and accounting standard features (Chapter 3), and managerial incentives and standard enforcement (Chapter 4). More specifically, regulation comprises the principles-based nature of IFRS (Section 3.2), loan loss models (Section 3.3), as well as disclosures and presentation format (Section 3.4). The literature review is followed by an overview of the essays and the Licenciate thesis (Runesson, 2010) that lay the foundation for the essays (Chapter 5), with the intention of showing the links between this thesis and prior work, as well as describing in more detail what is done and found in each essay. An overview of the research design and data are provided in Section 5.6, and lastly, conclusions and contributions are summed up in Section 5.7

1.3 Chapter summary

In this chapter, I introduce the reader to the idea that financial accounting can have an information role in capital markets. As such, the quality of the provided information is of consequence and has been the focus of much research in the accounting field. The three essays that constitute a major part of this thesis have been presented briefly and the accounting quality issues in relation to each, have been highlighted.

2

Capital market effects of financial reporting

2.1 The information environment and corporate disclosures

In their review of the empirical disclosure literature, Healy and Palepu (2001) begin with the claim that corporate information dissemination is 'critical for the functioning of an efficient capital market.' Such information encompasses that which is provided by firms by way of formally recognized items (those found in the balance sheet and income statements of audited financial reports), mandatory disclosures in supplementary notes, and voluntary disclosures (information in various shapes and forms in otherwise regulated reports, as well as public announcements and investor relations activities). The reason for their claim is that in the presence of asymmetrical information between buyers and sellers, it is believed that markets will not work as well, or break down entirely, as good and bad products cannot be distinguished from one another and thus cannot be properly priced. This may take the form of *adverse selection*, which occurs when buyers or sellers who offer the worst deal are systematically overrepresented due to lack of information.[2] In its extreme form, this phenomenon results in the classic 'lemons problem' in economics (see Akerlof, 1970).[3] Both parties would

[2]Although used in economics, the term originally appeared in the insurance industry, as buyers of insurance are not representative of the population as a whole, but are rather more likely to perceive a higher probability of economic loss; this causes insurance companies to raise premiums for all buyers, since they cannot tell a high-risk buyer from a low-risk buyer.

[3]A simplification of the 'lemons problem' can be summarized as follows. If bad cars ('lemons') cannot be distinguished from good cars in the used-car market, potential sellers of good cars are discouraged from entering the market, as the market price—for a car at any quality-level—is lower than the perceived value by the seller. This is because the market price reflects investors demanding a discount on goods they have no information on. Because only cars of a quality equal to or less than the market price are offered, and buyers know this, a

benefit from the transaction, but due to lack of information, no transaction occurs and thus there is no optimal allocation of resources in the economy. How does this translate to companies, or to a capital market setting? It has been widely suggested that in the presence of no or insufficient information, firms must offer their shares at a discount, i.e., the cost of capital (what firms must sacrifice in order to gain access to capital) increases (Easley and O'Hara, 2004; Kothari et al., 2009; Lambert et al., 2007).

Assuming the 'lemons problem' is overcome and a transaction is carried out, once an investor has decided to invest, he may face additional 'agency problems' (see Fama, 1980; Jensen and Meckling, 1976) in scenarios where the seller is an entrepreneur. The entrepreneur or manager (agent) is, according to the theory, believed to have interests that are misaligned with the capital provider or investor's (principal's) and to act self-interestedly to the detriment of the investor. Accounting is said to be able to reduce information asymmetry also in this scenario (and thus mitigate the agency problems), for instance via optimal contracts that align the principal's and agent's interests.[4] Disclosures may here be used as the basis for contracting, or—especially if mandated—they may increase transparency directly. In order to achieve the desired effects, however, the accounts have to possess certain qualities, and be of *high quality*. Due to the nature of the agency relationship, managerial incentives that thwart the purpose of the information itself are expected to exist, which reduces the usefulness of the accounts (the effect of incentives on accounting outcome is discussed further in Chapter 4).

The above description captures two commonly stated roles of accounting (see, e.g., Watts and Zimmerman, 1986)—the valuation role of accounting and the contracting role of accounting. In considering the usefulness of accounting for capital providers' decisions to buy or sell equity or debt, it is primarily the valuation role that is in focus in this text.

2.2 Disclosures and firm transparency

An underlying assumption of the valuation role of accounting is that capital markets are imperfect and that transaction costs (including information search costs) exist. This is a necessary condition for financial accounting to play a role in capital markets. Several market effects of (voluntary[5]) disclosure have indeed been demonstrated empirically: increased analyst following and more

new equilibrium is set at an even lower rate, with potential buyers demanding an even greater discount. Eventually, only cars of near-zero quality are offered, indicating market break-down.

[4]Other ways of reducing information asymmetry, with or without accounting, are via the board of directors, with a monitoring and disciplinary role, or information intermediaries, such as financial analysts and rating agencies, acting as undercover agents (Healy and Palepu, 2001)

[5]Presumably, mandatory disclosures have similar consequences, but tests of this are less common due to the lack of variance in a sample of such disclosures.

accurate and less dispersed analyst earnings forecasts (Hope, 2003; Lang and Lundholm, 1996), improved liquidity (Bushee and Leuz, 2005), reduced bid-ask spreads (Coller and Yohn, 1997), and lower cost of equity capital (Botosan and Plumlee, 2002; Kothari et al., 2009; Lambert et al., 2007) as well as debt capital (Sengupta, 1998). The lower the information asymmetry, the more active investors become (see Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994). Under information asymmetry, less informed traders hesitate to make investments since they cannot be sure trading is carried out at a 'fair price". If disclosures raise participation in the capital market, liquidity increases, also raising efficiency. As regards reduced cost of capital due to disclosures, the idea is that investors perceive an information risk in the absence of disclosures, and this risk increases the required return on investments. However, those familiar with the Capital Asset Pricing Model (CAPM) know that investors only consider non-diversifiable risk (at least in theory). Hence, the underlying assumption that a firm's cost of capital is compensation for risk, implies that an observed higher cost of capital due to information asymmetries is evidence of the existence of non-diversifiable information risk. It is debatable whether information risk *can be* non-diversifiable, as it at first sight seems firm-specific. However, it has been shown analytically that different aspects of this risk are indeed non-diversifiable (Easley and O'Hara, 2004; Hughes et al., 2007; Lambert et al., 2007). Studies that provide empirical evidence of this or otherwise examine the economic effect of disclosure, abound in the literature (although, admittedly, often without clarifying the underlying economic theories). A commonly cited study that indicates a negative association between disclosure level and the cost of capital is that by Botosan (1997). However, the association is established only for firms with low analyst following. This is explained in terms of analysts partly acting as substitutes for corporate disclosures, and the annual report (which is used to measure disclosure) thus carrying higher weight for firms with fewer analysts. Botosan and Plumlee (2002) extend the sample in Botosan (1997) and identify three different disclosure types: annual reports, quarterly reports (or other timely disclosures), and investor relations activities. One conclusion is that disclosure *type* matters. While annual report disclosures have a reductive effect on cost of capital, more timely disclosures increase stock price volatility (another common proxy for cost of capital), with the latter result being explained by 'short-termism'—investors trading ferociously on the latest earnings news, regardless of future earnings potential.[6]

The documented negative association between voluntary disclosure and cost of capital is also supported by Francis et al. (2008). They do not settle for the simple association between these variables, however, but introduce earnings

[6]Christensen et al. (2010) point to the importance of choosing an appropriate proxy for the cost of capital, depending on whether short-term or long-term cost of capital effects are to be considered. Cost of capital can rise in the period leading up to the disclosure (because of earnings news building up), offsetting any cost of capital reductions occurring posterior to the disclosure.

quality to their model. The previously documented association then disappears, which suggests that there exists a complementary relationship between earnings quality and disclosure quality (this stands in contrast to what is suggested by Lang and Lundholm, 1993). Good earnings quality is positively associated with the self-constructed disclosure index[7] used by Francis et al. (2008), and when they exclude earnings quality from the model, there is a correlated omitted variable distorting the results in favor of disclosures. The conclusion to be drawn from this is that firm transparency in the form of voluntary disclosures, even when not the primary explanatory factor of cost of capital, is associated with earnings quality, and higher earnings quality lowers user uncertainty about firm performance. Because earnings quality and disclosures are both aspects of accounting quality, either way, there is evidence in this literature of accounting—and its quality—playing an information role in the market.

2.3 Investors' valuation of accounting

Moving on from cost of capital effects of disclosures and more general firm transparency, research has also focused on investor responsiveness to different line items, such as net income, common equity, or changes in these. Essentially, there has been an interest in how movements in stock prices or price derivatives (such as stock returns) covary with accounting numbers. The logic behind this is that earnings measure changes in the *book* value of equity, while stock returns measure changes in the *market* value of equity (where the value of equity captures the net present value of discounted future cash flows to equity-holders). If the market value or price of a stock is the market value of a firm's equity, then stock price changes (stock returns) should be related to changes in the book value of a firm's equity. One may object to all of this and point out that market values are nearly always higher than book values. This is true, but this is mostly due to managerial conservatism in accounting and also to the strict asset definitions and recognition criteria in standards.[8] Market values capture future earnings, while book values may not contain unearned, future income. Nevertheless, market values should *covary*, or 'move together', with book values. If the correlation between the variables is high, we say that the 'value relevance' of earnings and/or book values is high. High value relevance is thought to be a sign of high earnings quality (Dechow et al., 2010). The reasoning behind this is that if the market observes changes in the accounting numbers and revises its valuation based on the new information, these revisions may indicate that

[7] It should be noted that these results do not seem to be robust to alternative disclosure proxies.

[8] An asset may only be recognized as an asset if *control* over the asset can be certified and there are highly *probable* future economic benefits tied to the asset that can be estimated *reliably*.

the numbers are considered reliable and relevant.[9] The question from a policy perspective, then, is how to shape accounting standards that encourage firms to produce accounting numbers that are useful (value relevant) to investors.

Starting with Ball and Brown (1968) and Beaver (1968) in accounting, and Fama et al. (1969) in finance, all of which looked at investor responsiveness to earnings announcements, countless studies have since discussed the usefulness of accounting numbers by taking a market perspective. The idea of usefulness being of central importance can easily be traced back to the pre-Ball and Brown/Beaver era of normative, policy-oriented research (see discussion in, e.g., Watts and Zimmerman, 1986). During the late 1980s as well as throughout the 1990s, the earnings-returns relation received much attention, and the concept of value relevance was popularized in the financial accounting literature. There are three main types of such studies (Holthausen and Watts, 2001): relative association studies, incremental association studies and marginal information content studies. The former aim to determine which bottom line accounting numbers (e.g., based on different GAAP) are more closely associated with a given market measure, with a high fit of the model (typically with respect to R-squared) indicating a more value relevant accounting number; the second type of studies focuses on the long-term relationship between accounting item values and market prices or returns, where a high item relevance is indicated by whether the regression parameters are significantly different from zero or equal to some theoretically sound value; finally, information content (event) studies are based on short-windowed associations between accounting numbers and market data when a new information item is released. Whereas the abovementioned studies by Beaver (1968) and Fama et al. (1969) may be classified as event studies—since they focus on market behavior leading up to, or subsequent to, some earnings event—the so-called association-based studies have also flourished (Barth, 1994; Collins et al., 1997; Easton and Harris, 1991; Easton et al., 1992; Ge et al., 2010; Harris et al., 1994; Hung, 2001; Ohlson and Penman, 1992). The literature that compares the valuation implications of disclosures versus formal recognition of items have widely relied on this type of value relevance setup (Amir, 1993; Barth et al., 1992; Choi et al., 1997; Davis-Friday et al., 1999), as have studies that have evaluated the effect of IFRS adoption (Aharony et al., 2010; Barth et al., 2008, see next chapter).

In all instances, usefulness in terms of relevance or reliability (faithful representation) is inferred from high value relevance. It may be noted that the value relevance of earnings and book values has been documented to have decreased over time (Brown et al., 1999). An explanation for this lies in shifting business models and increased prevalence of intangible assets. Intangible assets are less likely to meet the definition of an asset according to the standard, and they

[9] Need the markets be efficient for this to be a sensible measure and would this not then be contradictory to other assumptions? It depends on how market efficiency is defined, but at least it assumes some sort of investor rationality (Barth et al., 2001).

especially fail to meet the recognition criteria; in fact, some types of assets are believed to never meet the criteria, such that IFRS prohibits their recognition *ex ante*. Hence, book values of equity and, as a consequence, GAAP earnings, are less reflective of intrinsic values or firm performance as measured by the stock market.

Finally, it may be noted that whereas causality is usually inferred from the above value relevance studies, caution is perhaps warranted when evaluating results from association-based studies. Also, value relevance studies have waned in popularity after criticism has been put forward regarding their allegedly atheoretical applications. The following is an extract from Runesson (2010), in which associated-based tests are used:

> As was pointed out early on by Beaver and Demski (1974), and twenty-five years later regained focus after a trenchant article by Holthausen and Watts (2001), it is not to be assumed that an observed association between accounting data and market data provides an indication of what constitutes a superior regulatory policy. Nor can usefulness be evaluated outside a designated context. In order to translate high statistical associations with 'good' accounting, or superior accounting quality, a solid and descriptive theoretical foundation is first needed. In fact, to even assume that standard setters, such as the IASB and the US Financial Standard Setting Board (FASB), create standards (solely) for the benefit of investors and the purpose of equity valuation, is heavily criticized by Holthausen and Watts (2001). Kothari (2001) quotes Lee (1999), who goes so far as saying that association studies should have limited implications for standard setting unless it is desirable to have earnings reflect future earnings (a feature of market prices) and to thus relinquish the revenue recognition principle. Barth et al. (2001) make counterclaims to the above, however, and point out that the fact that although financial statements may be used for other purposes than equity investment, this does not diminish the potential impact that value relevance research—with its focus on equity investment—may have on standard setting. The research field helpfully operationalizes some of the concepts brought forward by the FASB—and, by extension, the IASB—such as reliability and relevance. [...] Value relevance research generally takes a [...] modest approach to usefulness, in that it is implied that usefulness is equivalent to 'being used"—an action follows, such as a price revision. Barth et al. (2001), however, note further that it is not even necessary to claim value relevance should reveal the 'usefulness' of financial statements or accounting numbers, at least not if by this one equates value relevance to decision relevance. It need not be new information that is contained within the financial statements in order for it to be relevant; the role of accounting is, after all, also corroboratory [confirmatory].

Although the present thesis makes little use of *value relevance* studies in the common sense of the word[10], the literature is, as partly evidenced by the above quote, central to any decision-usefulness discussion, and is directly related to the event study methodology in Essay 2.

[10]Holthausen and Watts (2001) report that 94 percent of the value relevance studies in accounting up to that time were association-based.

2.4 Chapter summary

In this chapter, examples have been given of the capital market effects of accounting. Given both the information and valuation role of accounting, financial reports can help users make better investment (or loan) decisions, but how the accounts are shaped will be of consequence in this context. Accounting quality, including the quality of earnings, the quality of disclosures (voluntary or otherwise), and the value relevance of the accounting numbers, becomes a factor here. The next chapter explores various elements of accounting standards—one of the alleged determinants of accounting quality.

3

Regulation of financial reporting and accounting quality

3.1 On the regulation of accounting

In a world with so much regulation, asking whether it is needed might seem like a nonsensical question; after all, rules are arguably required to maintain some sort of order in a civilized society and laws are needed to curb inappropriate behavior and help uphold societal standards. It serves one well to remember, however, that the same person making these claims may also believe in free trade and free markets along the lines of modern-day commercialism. Is it possible then to consider leaving information distribution to the market, that is, using a market approach to determine the optimal level and type of accounting information and disclosure? Clearly, firms willingly provide more information to shareholders and other interest groups than required by standard setters and governments. They do this in part because they want to avoid informational asymmetry problems, which are detrimental to the firm and its management; they also do this to protect their reputation, as a response to lobbyists, political pressure and current social norms (today it is, for instance, increasingly important to show environmental awareness and humane treatment of workers in the supply chain). Meanwhile, agency problems can allegedly be solved by means of optimal contracts and various monitoring mechanisms, eliminating the need for accounts imposed by force. So need accounting information be regulated, or is it provided satisfactorily without external pressure? In fact, rationales for governmental or even supra-governmental regulation of accounting information abound. Early rationales—derived from management's information advantage, the presence of naïve investors, and the diversity of accounting

procedures (Watts and Zimmerman, 1986)—probably have some merit, along with competing motives backed by economic literature on market failures and on accounting being a public good that is likely to be underproduced. It is beyond the scope of this text to determine which formal motive is more accurate; rather, it is useful to accept all of them as partly true and contributing reasons for giving standard setting attention.[11] Furthermore, a recent study indicates that although voluntary information can reduce information asymmetry, mandatory disclosures play an important complementary role as a commitment mechanism; at least for small firms, market illiquidity increases when disclosure regulation is relaxed—even when the affected firms voluntarily maintain their disclosure level (Cheng et al., 2013, cf. Leuz and Verrecchia, 2000).

However, even if we accept that some information needs to be mandated, it is not obvious how this should be done. Which standards should be used, what form should they take, and how detailed should they be? Which type of information should be regulated? Which mandated information should be recognized directly in the financial statements and which should be included as supplementary disclosures? Which items should be recognized where, and what should constitute net income, or comprehensive income? Although I do not provide direct answers to these questions (it is doubtful whether anyone could), it is relevant to consider all of them where high-quality accounting is concerned, and they serve as a useful point of departure for the ideas presented in the sections below and, consequently, for the essays.

3.2 Principles-based accounting and International Financial Reporting Standards

A substantial amount of research carried out now is concerned with comparing IFRS with local Generally Accepted Accounting Principles (GAAP), including US GAAP. When recipients of financial reporting are capital market participants (under IFRS or US GAAP) rather than tax authorities (under some other local GAAP), disclosure quality tends to rise (Aharony et al., 2010; Daske and Gebhardt, 2006; Leuz and Verrecchia, 2000), suggesting transparency is more associated with these larger, overwhelmingly Anglo-inspired frameworks. On the other hand, since various financial reporting scandals took place in the early 2000s, the US Securities and Exchange Commission (SEC) came to question the effectiveness of US GAAP as a prevention tool for accounting manipulation (SEC, 2003), and speculated that bright-line rules, characterizing the rules-based US GAAP, may create loopholes for manipulation rather than prevent it.

[11] Note, however, that even if the rationales above are reasonable, a cost-benefit analysis is rarely carried out by researchers (Fields et al., 2001), and it may be that changing standards or procedures is not warranted after such an analysis. Measuring the costs to countries and firms (and investors in the end) is, in fact, nigh on impossible, as is estimating the benefits. The present study considers accounting quality separately from such considerations.

The last decade has witnessed an increased focus on principles-based accounting standards as a possible remedy for these problems (see e.g., Benston et al., 2006; Bhimani, 2008; Schipper, 2003), with IFRS being a framework popularly characterized as principles-based (Bennett et al., 2006; Carmona and Trombetta, 2008).

Although there is no official definition of what principles-based accounting standards are, they have been contrasted with rules-based standards in terms of the relatively high amount of judgment or discretion that they allow (and require) in the preparation of financial reports (Benston et al., 2006; Nobes, 2005; Schipper, 2003). In exercising professional judgment, the underlying economics and substance of the events being accounted for can allegedly be better portrayed; this is ultimately due to management being able to convey private information (Fields et al., 2001)—provided it has the incentive to do so. This, in turn would mean that a faithful representation of the transaction—a prerequisite for usefulness or quality of accounting—can also be achieved (Bennett et al., 2006; Schipper, 2003). In comparing high- and low-judgment settings, and suggesting that more judgment benefits investors due to managers' conveyance of private information, one seems to be stepping away from the ingrained belief promulgated by agency conflict theories, that managers will take every opportunity to manipulate outcomes and mislead investors. However, by no means is it claimed that management will go out of its way to put outsiders at an informational advantage, or that firms will not act self-interestedly; the underlying reasoning is simply that the benefits of increased judgment will outweigh the costs—unless, alternatively, principles-based standards may act as a more effective deterrent to incentives-driven accounting. Agoglia et al. (2011) provide some evidence along these lines, in showing that the more principles-based a standard is, the less prone management will be to report aggressively; this is presumably because they are *more* afraid of litigation and the consequences of not following the 'spirit' of the standard. The authors also show that whereas having a strong audit committee restrains aggressive reporting under rules-based standards, this has no discernible effect under a less precise (more principles-based) standard.

Since the adoption of Regulation (EC) 1606/2002 (EC, 2002) by the European Union, IFRS has been mandatory since 2005 for listed firms preparing consolidated financial statements. An important objective of introducing IFRS was to achieve increased comparability and harmonization, with the final objective being that financial reporting should become more useful and relevant to investors (EC, 2002).[12] A number of recent papers have studied the effects of

[12]The European Union has tried to harmonize financial reporting for several decades. In 1978 the 4th Directive, aiming to harmonize single company accounts, was adopted. This was followed by the 7th Directive, for consolidated accounts, in 1983. The directives were not principles-based but they did give substantial implementation latitude to individual countries, resulting in weak harmonization, at least pertaining to measurement issues. Therefore, the real level of harmonization was lower than intended by the EU (e.g., Flower, 1994; Haller, 2002). In 1993 the listing of Daimler-Benz on the New York Stock Exchange highlighted

replacing local GAAP with IFRS (see Text Box 1 in the next section). Much of this literature is focused on the general accounting quality effects of introducing IFRS—with mixed results. Although it is evident that the EU made a choice to adopt IFRS, it did not make a choice to promote principles-based standards per se. Rather, that is the choice of the IASB, as the IASB views principles-based standards as the means to achieve global harmonization (see a thorough overview in Lundqvist, 2014). Thus, having principles-based standards is not a political goal in itself in the EU, and the effect of such standards is an empirical issue. In fact, opinions about the principles-based nature of IFRS have been far from unanimously positive. Rather, some features of IFRS, such as the use of fair value in some instances, have been criticized (e.g., Ernst & Young, 2005; Hughes, 2008; Laux and Leuz, 2009). Thus, the issue is still open as to whether the additional judgment feature of IFRS compared with previous European accounting is beneficial for users of financial statements.

3.3 Earnings quality and loan loss provisioning in banks

As Penman (2011) states in the introduction to his book *Accounting for Value*:

> [Investors have] straightforward questions, such as 'What did I earn this year?' and 'What did my firm earn?' They seek accounting summary numbers, like earnings, to treat as real numbers, to be relied upon. But again, the question is: What is a good summary number for the purpose at hand? / The cynic claims 'There is more than one earnings number, it depends on how you measure it.' Possibly so, for measurement is difficult; perhaps we cannot hope for one number to capture all the texture of a firm's operations.

There is no denying it: an earnings number is not a god-given number, and accounting standards are not part of God's ten commandments, written on stone tablets as an eternal law. There is, in fact, no such thing as *true* earnings[13,14] Earnings are merely a construct forged out of a tenuous consensus among standard setters; that is, even if a firm could measure those earnings

the effect of worldwide differences in accounting standards, as Daimler-Benz had to produce financial statements in accordance with both US and German GAAP (Von Colbe, 1996). With increasing cross-border investments on stock markets, there was a debate in the EU on how to achieve real harmonization, at least for listed firms.

[13]This may be highly disturbing to some people, especially those analysts and investors seeking to summarize performance or predict the future with as few summary measures as possible. The doubt that this might cast on the purpose of the entire accounting profession, or on the skill of standard-setters, is perhaps also inevitable (see Van Cauwenberge and De Beelde, 2007, for a discussion on dual income display).

[14]Does this make earnings numbers meaningless? There is a discussion of this by Watts and Zimmerman (1986), where they refer to early accounting researchers who indeed questioned the meaning of earnings numbers. Not only are they determined by the current rules, but they are subject to choices about their individual components, such that an earnings number is really a sum of 'two apples and three pears'. Perhaps fortunately for accounting researchers, research that followed showed that earnings numbers were relevant after all (cf. above-mentioned market studies).

without uncertainty, unless there is universal agreement on what should be estimated, a set of accounting standards will inevitably be imperfect. Standards can be considered to improve over time, but they will arguably always be in a state of flux. As we saw above, there are also many competing standards globally.

Not only disclosures but also earnings numbers will thus vary with regulation, as will their quality. Of course, even if regulation were identical everywhere for every firm and managerial incentives did not exist, the actual outcome of a process aimed at producing accounting that complies with regulation, would depend on the individual accounting methods and policies used within a firm. For in all existing frameworks, different accounting options are available to firms. Depending, for instance, on which valuation and depreciation methods are used, there will be differential earnings (quality) effects. When firms choose to use a linear depreciation method, it may be on the grounds that it is more reliable or less subjective, but does it give relevant and therefore useful information? As for depreciation versus impairment (of, e.g., goodwill), questions have been raised as to which approach gives more useful information. Based on the findings presented above as well as below, subjectivity and management discretion may be useful—supporting the impairment-only approach—but proper enforcement is necessary.

What it ultimately boils down to is whether a certain prescribed method or approach for arriving at an earnings number (via individual income and expense items) raises earnings quality. As mentioned briefly above, *earnings quality* is one aspect of accounting quality, along with disclosure quality. Just as firm disclosures make previously private information public, earnings numbers convey information about firm performance and future potential. More formally and within the present framework, earnings quality can be defined as being high if it gives information about performance that is relevant for decision-making, where the type of decision and decision-maker is specified (Dechow et al., 2010). Without a specific decision model, the term is thus meaningless.

In attempting to capture the determinants and consequences of earnings quality, three categories of earnings quality proxies have been commonly implemented in the literature (Dechow et al., 2010):

- *properties of earnings:* examples include persistence, smoothness, asymmetric timeliness of earnings, (abnormal) accruals, and target beating;
- *investor responsiveness:* examples include earnings-returns models, and earnings response coefficients (ERC) and R-squared from these; and
- *external indicators of earnings misstatements:* examples include internal control procedure deficiencies or audit statements.

While investor responsiveness was discussed above (see Section 2.3), smoothing as a property of earnings will be considered next.

Text Box 1: Examples of studies that have looked at earnings quality effects of IFRS

It is of interest for standard-setters and researchers to identify those methods, policies and rules that maximize expected earnings quality. Comparing different accounting frameworks, and different GAAPs, are ways of doing this, *ex post*. Earnings management before and after IFRS adoption has therefore been a popular research topic. Papers include those that study effects of voluntary as well as mandatory adoption of IFRS—worldwide (e.g., Daske et al., 2008; Goodwin et al., 2008; Jeanjean and Stolowy, 2008) and in the European Union (e.g., Aharony et al., 2010; Barth et al., 2008; Callao and Jarne, 2010; Chen et al., 2010; Cormier et al., 2009; Paananen and Lin, 2009). A number of examples are provided below as a backdrop for my essays.

Evidence shows that income smoothing using discretionary accruals is lower for firms that follow IFRS or US GAAP compared to firms using other local GAAP, as well as for firms with a higher level of disclosure (Lapointe-Antunes et al., 2006), with the choice of accounting standard having more impact on earnings quality than disclosure level. Also, investors place less value on discretionary accruals when firms disclose more or report according to IFRS or US GAAP, suggesting these firms are more transparent and, consequently, earnings smoothing is more easily detected. Analysts' forecast accuracy is observed to increase upon IFRS adoption, as is the number of foreign analysts (Tan et al., 2011). Meanwhile, earnings management, as defined by the reporting of a greater proportion of small profits to small losses, is found to increase or remain unaffected by mandatory adoption of IFRS in Australia, France and the UK (Jeanjean and Stolowy, 2008). Increased earnings smoothing and less timely recognition of losses are found to be features of the post-adoption period also in Chen et al. (2010) and Ahmed et al. (2013). They show, however, that earnings management toward a target decreases (Chen et al., 2010) or is unaffected (Ahmed et al., 2013). Whereas discretionary accruals are found by Chen et al. (2010) to decrease after EU adoption of IFRS, Ahmed et al. (2013) observe more aggressive accruals.

A well-cited paper on the voluntary adoption of IFRS, which also uses several of the same quality indicators, is one by Barth et al. (2008). The quality measures used include earnings management, timely loss recognition and value relevance (R-squared). They find that quality improves in the post-adoption period, although the financial reporting standards per se cannot be proven to be the reason; rather, incentives that adopting firms may have could drive results. To at least partly control for this, variables such as growth, leverage and financing needs are introduced. The hypothesis that the improvement is in fact associated with a switch to IFRS is based on the (by now hopefully familiar) idea that principles-based standards, which characterize the IFRS, promote higher-quality reporting. Half of their measures support their hypothesis, where one aspect of earnings management is the frequency with which a firm reports a small positive net income and another is earnings smoothing.

One paper by Aharony et al. (2010) concludes that IFRS adoption is most beneficial when local GAAP deviates from or is less compatible with IFRS. That is, firms in these countries benefit the most from switching to IFRS. A comparability index is devised for the purpose of their study. Also, there is greater incremental value relevance of the studied accounting items under local GAAP (prior to IFRS adoption) for firms operating in countries where the standards were more compatible with IFRS, suggesting IFRS improves value relevance. This is based on evidence from value relevance tests pre- and post-adoption. The data comes from 14 different countries and 2,298 firms. The items focused on are goodwill, R&D and revaluation of PP&E. The authors decompose both a price model and a return model (see Section 2.3) to observe the coefficients of the individual accounting items (chosen *a priori* because they are thought to differ most significantly between IFRS and local standards).

Finally, it has been shown that analyst forecast error is negatively related to IFRS compliance (as measured by a disclosure index of selected IFRSs), suggesting IFRS disclosure requirements reduce information asymmetry (Hodgdon et al., 2008). The authors emphasize the importance of taking into account compliance when studying the effects of IFRS. Even though firms claim full compliance and despite the stricter regulation in the revised IAS 1, firms are not complying fully (see e.g. Street and Gray, 2001, and Glaum and Street, 2003, in Hodgdon et al., 2008). In sum, it is necessary to consider compliance and not just the standards when evaluating an accounting regime. Although Hodgdon et al. (2008) claim quite few studies consider compliance, they are emerging quickly (Essay 1 being one of them).

The way to measure smoothness is by setting income variability in relation to cash flow variability, where cash flow is a benchmark for unsmoothed earnings. If the ratio is high, smoothing is low, and vice versa.[15] Smoothness of earnings is not considered an ultimate goal of the accounting system. Rather it is an outcome of the accrual system, designed to present fundamental performance such that future cash flows can be predicted, and to minimize the mismatch between cash payments and receipts in the short run. Accruals are the core of the current accounting system (the alternative being 'cash [ac]counting'). Does this mean smoothness is good? Even if we disregard estimation difficulties and management choice, smoothness caused by accrual accounting is not automatically or inarguably desirable; it may also hide a firm's true or fundamental performance. Generally, evidence related to determinants and consequences of earnings smoothness provides unclear support for the belief or claim that smoothness is a good proxy for earnings quality, not least due to the effect of accounting choices and ambiguous motives for smoothing (i.e, are choices made to manage earnings or promote decision usefulness?). Barth et al. (2001) interpret smoothing as a negative feature, based on the earnings management hypothesis that predicts that low cash flows are compensated for through high accruals. However, as they themselves highlight, Dechow (1994) points to accruals as a smoothing feature of accounting that is *good*, meaning that a negative correlation between cash flows and accruals is indicative of high earnings quality. Earnings, after all, are meant to reflect value creation and take business cycles into account, whereas cash flows simply measure cash in–cash out. High variability in earnings could also be bad if it is related to extreme and/or inappropriate actions by management (e.g., 'big baths').

Turning our attention to the banking literature, in attempting to evaluate the outcome of using an 'incurred loss' or 'expected loss' model with respect to the quality of loan loss provisions, a conceptualization of quality must first be undertaken. Which quality measure to use is, as indicated above (see Dechow et al., 2010), not arbitrary. Measures previously used in the literature often focus on (the absence) of earnings management, such as the timeliness of loss recognition or indeed low smoothing (e.g., Ahmed et al., 1999; Bushman and Williams, 2012; Fonseca and González, 2008; Gebhardt and Novotny-Farkas, 2011; Liu and Ryan, 2006). Management of earnings can, by definition, be said

[15] Closely related to the notion of smoothness is persistence. Although persistence and smoothness are expected to be correlated due to their nature, the difference between them is apparent from their empirical constructs; persistence has to do with how the earnings number varies between periods (e.g., years), whereas smoothing has to do with how the earnings number relates to some external reference (although higher smoothness can indeed be associated with higher persistence). Persistence is a measure of how earnings from one year are carried forward into the next; that is, it is a measure of how sustainable earnings are, or in yet other terms, to what extent they are recurring. It is argued that persistence indicates high quality in that firms with more persistent earnings are thought of as having a more predictable earnings (and cash flow) stream, which makes them more useful for the discounted cash flow(DCF)-based equity valuation commonly used by investors.

to be detrimental to financial reporting quality and under the *private control benefits* hypothesis (Fonseca and González, 2008), insiders or managers subjectively manage earnings to suit their own needs, which could indicate that earnings smoothing is a sign of opportunistic behavior.

In an accounting context, management of either earnings (or capital ratios) is, by definition, detrimental to financial reporting quality. However, the definition of earnings quality is not self-evident but depends on the chosen objective function, such that identifying what constitutes high earnings quality (e.g., high or low smoothing, or a completely different measure?) can be thorny (not least when the objective function cannot be agreed upon). Deciding on the accepted policies and methods for calculating earnings is therefore a task that attracts the attention of both practitioners and scholars. The above concerns are relevant to Essay 3, in which we consider earnings quality and loan loss provisioning and present an alternative way of measuring accounting quality in the context of credit loss accounting. In trying to determine the relative merits of the 'incurred loss' model and the 'expected loss' model, it is not immediately apparent that the model that scores higher on a smoothing metric is superior. Due to the ambiguity of the smoothing measure, we focus instead on the ability of loan loss estimates to forecast actual losses. Because the purpose of estimated loan losses is indeed to estimate actual loan losses, the validity of loan loss provisions is hence captured in a more direct manner. The provision is thus not evaluated in relation to aggregate earnings (as when smoothing is used) but to a variable that is, at least in part, independent of the accounting system. Our model is derived from Altamuro and Beatty (2010), in which gross charge-offs (GCOs), i.e. actual loan losses in future periods, are explained by loan loss provisions (LLP). Nevertheless, we do expect smoothing to be correlated with the predictive ability of the provisions since smoothing is believed to be associated with a timelier recognition of losses. For this reason, and as indicated above, it may be argued that earnings smoothing (as well as a reasonable level of capital management) in banks is good. For example, from a socioeconomic perspective, capital regulation tends to have a pro-cyclical effect on the economy, in that unfavorable economic climates lead to higher risk exposure and higher capital requirements, in turn limiting available credit; banks tend to have 'inadequate' provisioning policies and make provisions too late, during economic downturns, instead of when conditions are favorable (Laeven and Majnoni, 2003). Smoothing (in the form of timelier provisions), in contrast, reduces volatility over time as earnings are decoupled from cash flow patterns. Also, from a bank-regulator's perspective, income smoothing may be used to lower investors' perception of risk in a bank (see, e.g., Fonseca and González, 2008). The risk management hypothesis suggests that there should be a positive relationship between earnings and loan loss provisions (i.e., via smoothing), as LLP are used in good times to increase reserves that will cover losses in bad times. It is here noted that although the risk perspective may be favored by bank regulators, the use of provisions to

cover as-yet non-incurred losses seems to go against some basic accounting principles, which stipulate that although LLP are made for expected future losses, they should only exist where these losses are due to *events that have already occurred* (this may involve a type of trade-off with another basic accounting principle—conservatism). Wall and Koch (2000) question the meaning of an event having occurred, however, and suggest an alternative way of viewing the matter (e.g., if the loss event is defined as the actual act of lending, there is no conflict). The above reasoning helps justify the belief that earnings smoothing can be a sign of high rather than low earnings quality, and aims to illustrate why it may be a controversial measure.

3.4 Presentation format and post-employment benefits

In this section, rather than focusing on what constitutes high quality of the numbers, I consider the role that 'form', or 'format', plays in accounting quality. As an example, one may consider items that are disclosed in the supplementary notes to the primary financial statements, versus items that are *formally recognized* in the (primary) financial statements. Depending on the way the content is presented, there may be different valuation implications for investors. Whether this depends on whether the format reflects some underlying substance of the numbers, or carries meaning in itself, is as of yet an unresolved issue. Moreover, one may ask if the meaning attributed to the form or placement is accurate, or if investors are led astray by, for instance, the complexity of certain presentations and potential lack of transparency? The reliability and relevance of an item are often considered in this context and are notoriously difficult to determine. Is an item treated differently by investors because it is less reliable (regardless of presentation format), or are they reacting to the presentation format, which may or may not originate in a lack of reliability? For instance, are unrealized gains and losses on securities held for sale less reliable because they are not in the income statement, or are they not in the income statement because they are less reliable? Could it even be that the presentation format *causes* lack of reliability, for instance due to lower managerial or audit effort in relation to some items?

Research questions that stem from the acknowledgment that format might matter, include how investors are affected by different presentation formats of other comprehensive income items (Maines and McDaniel, 2000) and how easily earnings management is detected under different accounting treatments of said items (Hirst and Hopkins, 1998). To elaborate on this: when speaking of the 'earnings' of a firm, one could be referring to a number of different measures, or *line items*, of the income statement. Primarily, one might consider gross profit, EBITDA (earnings before interest, tax, depreciation and amortization), EBIT (earnings

before interest and tax), or net income (before or after preferred dividends). In recent years, so called 'dirty surplus' items—items that affect equity without passing through the income statement—have been eliminated in favor of items that enter the income statement as *other comprehensive income*. Other comprehensive income (OCI) appears below the net income figure, and together, a new bottom line is created, known as comprehensive income. This transition originated in a belief in the transparency gains that such a change in treatment would bring about (see Barth and Schipper, 2008).

Many studies on this topic were motivated by the introduction of SFAS No. 130 *Reporting Comprehensive Income*. Although SFAS No. 130 came to allow different presentations of comprehensive income, the original idea by the FASB was that a separate statement of comprehensive income (rather than simply presenting the amounts only in the statement of changes in equity) would help investors actually use the measure and reflects the belief that the measure carries relevant information (see the exposure draft to the standard). Some corporate managers were against this because they did not believe that all the movements in comprehensive income were reflective of underlying firm performance, which led to the standard allowing a choice between the different presentation formats (see Maines and McDaniel, 2000). Overall, proponents of comprehensive income consider it a more complete measure of performance than net income, while critics think it contains too many extraordinary and nonrecurring items, making it volatile and less useful. A conclusion drawn from one study (Maines and McDaniel, 2000) is that the intended objective of SFAS No. 130 (which includes enhanced visibility and increased use of the comprehensive income information) cannot be said to be achieved when the different choices lead to different signals being sent out to investors. Meanwhile, Hirst and Hopkins (1998) believe the placement of the OCI items matter based on behavioral research that suggests information should be not only available but also 'readily processable'. This would explain why they find that earnings management is more difficult to detect when other comprehensive income is reported as dirty surplus. Dhaliwal et al. (1999) ask whether comprehensive income is superior to net income as a measure of firm performance and find comprehensive income measures under SFAS No. 130 not to be value relevant when presented as 'dirty surplus', i.e., in the statement of changes in equity rather than as part of the income statement. As they do not consider the role of presentation format, however, no conclusions can be drawn about what would occur had the items actually been moved to the income statement.

In their analytical paper, Barth et al. (2003) refer to the 'ongoing debate' over recognition versus disclosure as the motivation for their modeling. They argue that although the efficient market hypothesis suggests disclosures in the supplementary notes should be sufficient for investors, standard setters believe—and past findings suggest—that recognition in the primary financial statements

matters and provides incremental information to the market, affecting investor perception of firm value (and risk). As no consensus is considered to have been reached on why there are differential market effects, the paper aims to discover under what conditions differences exist. Empirical papers have also attempted to do this. Considering SFAS No. 87 *Employers' Accounting for Pensions*, the standard requires that firms whose accumulated benefit obligation exceeds the fair value of the pension plan assets report a pension liability, while only a disclosure in the notes used to be made under the previous standard (SFAS No. 36). Harper et al. (1987) find that users treat formal recognition differently than disclosures; when considering debt-to-equity ratios, liabilities in the balance sheet were factored into the debt amount, but this was not the case for liabilities in the supplementary disclosures, with no difference observed between sophisticated users (professional bankers used to making loan decisions) and less sophisticated users (undergraduate accounting students). Amir (1993) went on to look at the extent to which investors fully impound in their valuation the full accumulated (non-pension) post-employment obligation prior to the implementation of SFAS No. 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions*. The introduction of SFAS No. 106 required employers to accrue the costs of all non-pension post-employment benefits, rather than report expenses on a pay-as-you-go (cash) basis. The switch from cash-basis accounting to accrual accounting meant firms faced increased expenses (in the current period) and increased liabilities (with the effect being a reduction in net income, retained earnings and owners' equity). Essentially, non-pension post-employment expenses were, prior to SFAS No. 106, not matched to the income generated by employees in the current period. As previously private information about these benefits would become available under No. 106, investors would allegedly benefit. The author believed that although the liability was already value-relevant to investors[16], it would become more so if estimation of the benefit could be made using private rather than just public inputs. This last assumption is based on the belief that recognition is indeed superior to disclosures with respect to information usefulness. This was further tested by Davis-Friday et al. (1999), who found that disclosure and recognition of the non-pension liability in question have different valuation implications for the market; the same item was given higher value when formally recognized as opposed to being just disclosed.

As indicated in the introduction to this section, the reasons for the above findings are commonly related to the idea of reliability. That is, disclosed and formally recognized items are treated differently due to them not being equally reliable. As suggested by Schipper (2007), there are a number of caveats with

[16] At the beginning of the period (1984–1986), investors valued cash payments toward the post-employment benefits only at a dollar-for-dollar rate, and not taking into account future obligations tied to the payment. Between 1987 and 1990, however, the present value of the APBO (estimated by the researcher) was value-relevant, incrementally to the cash payments.

the above and other related research methods, in that any conclusions as to reliability differences in disclosed versus recognized items assume investors process the information in the same way, regardless of presentation format; that is, investors are assumed to be unaffected by cognitive limitations. Furthermore, results from the commonly adopted value-relevance studies, where market variables are regressed on disclosed and recognized items, tend to imply that higher coefficients (higher valuation weights) mean more reliability. Ideally, the valuation weights should be considered in relation to their theoretically correct value. Later studies have also allowed for the possibility of information being excessively complex, with Picconi (2006) explicitly offering this as an explanation for why disclosures are treated differently from formally recognized items. These ideas are explored further in Essay 2, as it investigates differences between disclosures and recognition.

3.5 Chapter summary

This chapter gives an overview of three regulatory issues is particular: those related to principles-based accounting, implications of accounting standards for earnings quality and measures of earnings quality, as well as the role of presentation format in determining accounting quality. The three sections represent the three topics that are further explored in the essays.

4

Incentives, enforcement and accounting outcomes

4.1 Accounting choice, managerial incentives and enforcement

The literature is voluminous in the area of management's reporting incentives, not least because of how the topic relates to agency conflicts and adverse selection. Literature on accounting choice (see Fields et al., 2001, for a review) examines incentives extensively, relating these to desires to achieve certain valuation or contracting effects. Managerial incentives are therefore of consequence when examining the potential benefits of a certain standard or accounting framework. Essentially, and in addition to the standards themselves, incentives may be seen as potentially important determinants of accounting quality (be it disclosure or earnings quality). For instance, when discussing the benefits of principles-based accounting, more room for judgment is often also taken to mean more room for incentives-driven accounting choices. One must therefore consider the trade-off between letting managers use their judgment to convey their private information, or letting them potentially distort the reporting outcome (cf. the decision to make disclosures about estimation uncertainty in accordance with IAS 1, or the estimation of credit losses). Furthermore, in dealing with the distinction between disclosures and recognition, one acknowledges the possibility of there being incentives behind the choice of accounting method. In the particular case of actuarial gains and losses in IAS 19, disclosures only in the notes are synonymous with *less* transparent methods that could be used to hide losses and reduce undesirable volatility and thus outsiders' perception of risk. Whether agency theory, adverse selection theories, or even political process theories, are used to explain disclosure and accounting choices more generally, a central concept is 'information asymmetry' and the belief held by management that accounting

choices can affect perceptions of the firm.

Acting as a counterweight to incentives is enforcement. By enforcement, one may be referring to enforcement on a national or supranational level, or to firm-level monitoring mechanisms that help ensure that desired accounting outcomes are achieved. It is reasonable to believe that enforcement should be of consequence even in the absence of incentives, with the difference being that any accounting quality defects would then be expected to be mainly noise and not reflect any managerial biases. However, the presence of incentives arguably makes enforcement all the more important, especially when standards are principles-based (see discussion in, e.g., Ball, 2006).

Disclosures and earnings quality, as they relate to managerial incentives, are discussed in the next section. This is followed by a consideration of the role of enforcement in the context of incentives and principles-based accounting. The discussion below applies especially to Essay 1 and 3, as they consider incentives and enforcement explicitly and include proxies for both.

4.2 Managers' reporting incentives, disclosures and earnings quality

As stated previously, several theories exist as to why managers would prefer more or less transparency, or disclosure. Firms have incentives to reduce capital market transaction costs (adverse selection), agency costs and political or legal costs. A review of the literature also reveals a multitude of proxies for these incentives—variables that are used to measure a firm's inclination toward a certain behavior in the financial reporting context.

The first group of theories suggests that managers will make disclosure decisions in order to reduce adverse selection due to information asymmetry with market participants. Many empirical studies have identified determinants of (voluntary) disclosure that can be explained by capital markets-based incentives (see uses in, e.g., Barth et al., 2008; Bushee and Leuz, 2005; Lang and Lundholm, 1993; Leuz and Schrand, 2009; Leuz and Verrecchia, 2000; Nagar et al., 2003; Webb et al., 2008). An example that is closely related to the recognition-versus-disclosure debate comes from a study of synthetic leases; it is shown that firms with incentives to keep items off the balance sheet provide less transparent disclosures about such lease arrangements (Zechman, 2010). Common proxies for more general incentives include firm performance (high-performers have nothing to hide and will consequently want to be transparent in order to distinguish themselves from the low-performers) and financing needs (firms with greater financing needs are believed to have incentives to increase disclosure to reduce information asymmetries between management and creditors). Others include globalization level, ownership dispersion and complexity of operations; more

global and complex firms with many small shareholders will need to be more transparent in order to overcome information barriers and *home bias* (the tendency of investors to prefer investments in close geographical proximity to their domicile (Mavruk, 2010)).

The second group of theories focuses on boards, executive compensation, shareholder rights and other aspects of corporate governance. Some features will promote transparency, while others will have the opposite effect. The *corporate control contest* hypothesis suggests that managers will disclose information about the firm in order to secure their jobs in the event of a corporate takeover following poor (stock or earnings) performance. The *stock compensation* hypothesis, meanwhile, suggests that disclosures can be manipulated either to avoid undervaluation (an executive does not want an undervalued stock since it serves as a basis for his salary), or to actually encourage undervaluation (since an undervalued stock today means greater returns and thus higher bonuses tomorrow) (see more in, e.g., Healy and Palepu, 2001). This reasoning clearly counterpoises the view that executive equity-based compensation is a tool against agency conflicts, used to align the principal's and agent's interests. Another aspect of corporate governance is related to the room that incentives are allowed through the enforcement and monitoring role of strong governance mechanisms. For instance, firms with policies ensuring effective board functions, that comply with regulations regarding compensation committees, that have policies for ensuring equal treatment of minority shareholders and that have fewer executives as board members, are considered to have 'better' corporate governance according to many measures (see examples in, e.g. Verriest et al., 2013). Such firms are likely to be more transparent, resulting in a greater reduction of agency problems.

Lastly, political or legal cost theories generate political and litigation cost hypotheses. For instance, in order to avoid penalization, a manager is believed to increase disclosures in the wake of controversial events or circumstances. Alternatively, a manager may hope to avoid negative repercussions of undesirable outcomes by not disclosing certain facts (and hoping they are never brought to light). Large companies are typically more affected by these types of costs, which is why firm size is often used to proxy for the presence of potential political costs (e.g., Lang and Lundholm, 1993).

Just as accounting choice and managerial incentives affect disclosure outcomes, they may also affect earnings quality (for a review, see Dechow et al., 2010). Essentially, depending on a firm's characteristics, one might expect different levels of earnings quality, analogously to the case of disclosure quality, with applicable theories largely overlapping with those discussed in the previous section. Higher earnings quality is often taken to mean lack of earnings management, regardless of the final earnings quality proxy that is used (note, however, that poor quality need not imply the existence of earnings management since poor quality may

be unintentional). This comes naturally from the idea that firm incentives can lead to earnings being manipulated to achieve a certain outcome. In general, under a contracting perspective, indebtedness is believed to be negatively related to earnings quality as firms that are highly indebted and risk violating debt covenants are more likely to manage earnings (DeFond and Jiambalvo, 1994; Franz et al., 2014; Peasnell et al., 2000). Equity market incentives also explain earnings quality in that a firm with earnings-based targets is more likely to manipulate earnings. External factors in the shape of capital requirements, political requirements or processes, and tax and non-tax regulation, also shape incentives and ultimately earnings. I do not explore these in more detail, but an example is tax incentives when accounting and taxation are linked, leading a firm to want to lower its reported earnings figure.

In the bank literature, the potential use of loan loss provisions to manipulate earnings and capital ratios have been a major focal point (see Beatty et al., 2002; Hess et al., 2009; Kanagaretnam et al., 2004; Kim and Kross, 1998; Liu and Ryan, 2006; Liu et al., 1997), with incentives—or possibilities—to smooth earnings being governed by a number of factors (Fonseca and González, 2008). These include the level of investor protection and legal enforcement in a country, disclosure requirements, supervision and restrictions on bank activities.[17]

4.3 Enforcement of standards and other institutional factors

Whether we consider enforcement on the national or firm-specific level, the common idea is that enforcement will cause compliance with standards to increase; based on the assumption that standard setters strive for standards that improve accounting usefulness, compliance—and therefore enforcement—is desirable. As such, disclosures and earnings numbers are generally expected to be of higher quality the stricter the enforcement (cf. Essay 3 for criticism of this). Broad measures of national-level enforcement include whether the legal tradition in a country is categorized as *code law* (e.g., Germany and Scandinavia) or common law (Anglo-American countries), and which legal environment group a country belongs to according to the classification by La Porta

[17] The banking literature does not show strong support for the incentive hypothesis after Basel I and the improvement of enforcement mechanisms that the agreement implied, even though empirical results are somewhat mixed. Interestingly, lowering LLP in the old regime had a positive effect on earnings but a negative effect on the capital-adequacy ratio, such that there was a trade-off to LLP manipulation. As the capital-adequacy ratio was redefined under the first Basel Accord and the cost of understating LLP became lower, income smoothing was expected to increase (see, e.g., Rivard et al., 2003). These predictions have been widely tested, with some mixed results. Whereas findings in Anandarajan et al. (2007) and Rivard et al. (2003) suggest the predictions are well-founded, Ahmed et al. (1999) find no evidence of loan loss provisions being used to manage earnings. Basel II, which further increased supervision and disclosure requirements, was seen as further improvement as far as market discipline and earnings management go.

et al. (1998). It may be noted that different institutional environments can help explain properties of accounting earnings even when they are not interpreted strictly as variations in enforcement, but rather more loosely as accounting tradition (Ball et al., 2000). At any rate, when using legal environment as a proxy for enforcement, the underlying assumption is that some institutional settings promote higher transparency and are associated with stronger investor rights and more capital-oriented accounting traditions—an assumption that has also been criticized (Lindahl and Schadewitz, 2013). Ideally, one would like to measure enforcement more directly, and an attempt to this end has been made by Brown et al. (2014), who have constructed country-level enforcement indexes based on a number of parameters. Meanwhile, firm-level enforcement covers, among other factors, audit quality, the presence of intermediaries such as external analysts, and internal monitoring mechanisms within the scope of corporate governance. Audit quality is often proxied by the use of a Big 4 (6) auditor (Becker et al., 1998), (non-)audit fees and audit hours (see discussion in Francis, 2011), as well as the content of auditors' reports (including whether they are qualified or unqualified).

Studies that have investigated the effect of enforcement or legal environment on accounting outcomes include those that have found that forecast accuracy improves with enforcement (Hope, 2003), that globalization interacts with legal environment in determining disclosure outcomes (Webb et al., 2008), that banks' discretionary smoothing behavior decreases with stronger supervisory regimes (Bouvatier et al., 2014), and that earnings quality is higher for firms in countries with greater investor rights when (and only when) a firm has a Big 4 auditor (Francis and Wang, 2008). One paper by Liu (2014) shows that external monitoring in terms of a larger analyst following can constrain earnings management and is associated with timelier disclosures of bad news.

One study, which compares Asian countries with varying incentives (Ball et al., 2003), concludes that IFRS is not better than code law standards without proper enforcement. Some researchers will claim that accounting quality is all about enforcement and very little about standards or regulation. For instance, Christensen et al. (2013) is one paper that looks at the EU and concludes that apparent liquidity improvements of mandatory IFRS adoption are limited to countries where enforcement simultaneously underwent changes, and that liquidity improvements in fact also occurred in countries where enforcement changed but IFRS did *not* become mandatory. Whereas the implications of this is that IFRS itself had very little or nothing to do with said capital market effects, Barth and Israeli (2013) argue that such conclusions should not be drawn from the former study; enforcement may be required for the benefits of IFRS to materialize, but that does not mean IFRS does not also play a role in the improvements.

Meanwhile, findings on positive audit implications are exemplified by Zhou (2007) on auditing standard quality and reduced bid-ask spreads and Han et al.

(2012) on the size of the auditor and greater disclosure transparency, especially in code law countries (a proxy for weaker legal environments). Furthermore, there is evidence that lower audit effort (as measured by fewer billed hours) is associated with comparatively larger positive abnormal accruals and a greater incidence of positive rather than negative abnormal accruals (Caramanis and Lennox, 2008). Audit committees with higher pay (which is also correlated with expertise) demand higher monitoring of the financial reporting process (Engel et al., 2010), and lower audit committee independence is associated with higher abnormal accruals (Klein, 2002).

4.4 Chapter summary

This chapter briefly introduces the accounting choice and incentives literature. Theories on adverse selection, agency relationships and political costs predict why firms would choose certain accounting techniques or make disclosures. Various firm characteristics have been used as proxies for these theories. The relevance of this literature to accounting quality is the way in which managerial choices or judgment determine earnings quality as well as disclosure quality, not least where principles-based accounting is concerned.[18] Moderating effects may be provided by audit and enforcement factors, and therefore it is relevant to consider their effect on reporting outcome.

[18]It may be noted that the chapter's description of determinants of accounting quality is not meant to be comprehensive. The theories mentioned and firm characteristics used as proxies are, however, some of the most salient. Examples of firm characteristics that influence earnings quality that are not directly related to incentive structures are, for instance, firm growth and high investment levels; these may lead to lower earnings quality because of lower persistence in fast-growing earnings and due to higher measurement errors (in accruals).

5

The essays

5.1 Overview

In this chapter, I consider the three essays that constitute the bulk of this thesis. I return to the topics presented in the literature review, and draw parallels to the essays. One section is devoted to Runesson (2010) (the Licenciate thesis from which the ideas of the present work originated), along with a bridging study. The data and methodologies used are considered toward the end of the chapter, and finally, conclusions and contributions are summarized.

5.2 Essay 1

Essay 1 focuses on one distinctive aspect of IFRS, namely its principles-based nature and the impact that this feature has on disclosure quality in the EU. By focusing on one specific aspect of a standard, we attempt to increase the precision in the evaluation of accounting quality effects and reduce the *identification problem*—the difficulty of attributing certain effects to a given phenomenon—that many studies of IFRS adoption suffer from (Pope and McLeay, 2011). More specifically, in this essay we consider determinants of disclosures made in apparent compliance with IAS 1. The standard requires entities to provide information about material judgments, estimates and assumptions that have been made at that fiscal-year end. These disclosures are not only about judgments; they are subject to judgments themselves. They are mandatory, but all firms need not make a disclosure—this is due to the *materiality* criterion associated with the requirement; as is characteristic of principles-based accounting, firms use their discretion to determine whether there are material estimation uncertainties, and report accordingly. The presumed advantage of principles-based standards is that they may reduce the otherwise excessive and irrelevant dis-

closures caused by a box-ticking mentality induced by a *rules*-based system. IASB's recent Disclosure Initiative was initiated partly due to concerns of this kind, and many debates on the purpose and format of disclosures have taken place (EFRAG, 2012; FASB, 2012; IASB, 2013a,b, 2014). Whether the merits of principles-based standards hold in practice, however, remains open to investigation.

We find that principles-based mandatory disclosures are largely driven by the same factors as voluntary disclosures, such as the institutional environment (including enforcement) and incentives. This is taken as evidence that the room for judgment left to preparers of financial reports under IFRS may help exacerbate inconsistent application of the international standards.[19] In other words, the expected quality improvement brought on by IFRS due to increased disclosure requirements and judgment capturing the underlying economics in the firm, may not be achieved. On the other hand, even if said disclosures are indeed driven by discretionary factors, this does not mean they do not serve a purpose since they also appear to be driven by real, economic (i.e., relevant) factors. Because the underlying economics of the firm can never be directly measured, it must be proxied by features that are believed to capture estimation difficulties. Some of these proxies indeed explain disclosures.

We highlight that *more* disclosure is not necessarily a sign of higher-quality disclosure. Rather, a high level of disclosure reflects quality only to the extent that it is driven by economic factors believed to be related to material judgments and estimation uncertainties. Essentially, we recognize that although the disclosures should reflect underlying economics (and partially do), there is a 'voluntary' element to them due to their being discretionary, or subject to judgment. The substantial amount of *non-substantive* disclosures, and the tendency of even apparently substantive disclosures to be driven by underlying incentives, show that theories on accounting choice are applicable in the given context and influence the type and amount of information provided. We find, among other things, that firm size and foreign listings (a proxy for globalization) can significantly explain substantive disclosures. Furthermore, we also show that disclosure level and the likelihood of disclosing depend on the enforcement setting. Firm-specific enforcement, in the shape of differences in corporate governance structure or audit quality, determines these disclosures, as do different institutional settings, which, broadly speaking, can be likened—and linked—to national enforcement mechanisms. This is evidence that principles-based disclosures are only likely to work as desired when firms operate in an environment that promotes transparency. Additionally, to the extent that enforcement only causes superficial compliance (such as is evidenced by a high instance of non-substantive disclosures), one may question how enforceable principles-based disclosures are in

[19] See Lundqvist (2014) for more on *de facto* harmonization of financial accounting and consistent application of IFRS, and Pope and McLeay (2011) for a discussion about the challenges of IFRS adoption in Europe.

the first place. This we refer to as the *disclosure dilemma*—with the alternative of rules-based disclosures very likely being associated with an even greater 'box-ticking' mentality and loss of relevance.

Text Box 2: Disclosure quality metrics

In studying disclosures, typical underlying questions might be whether a firm complies with (mandatory) disclosure requirements, or whether a firm provides additional (voluntary) disclosures that are helpful to users. It is naturally of interest to measure the *quality* of disclosure, but what one often must settle for is *quantity* measures. Beretta and Bozzolan (2004) suggest that Quality = f(quantity, richness of content), while Botosan (2004) questions this and, based on the conceptual frameworks by the IASB and the FASB, suggests instead that Quality = f(understandability, relevance, reliability, comparability). Quantity being used as a proxy for quality is further criticized in a later paper by Beretta and Bozzolan (2008). At any rate, one is encouraged to consider what the disclosures should achieve (such as accurate and less dispersed analysts' earnings forecasts)—and construct disclosure metrics that are consistent with this.

The empirical literature uses various proxies for disclosure quality/quantity when attempting to test the impact of information dissemination on the market. The *voluntary* disclosure literature is perhaps the most creative in this context, and the reason voluntary disclosures are so attractive to measure, is that they exhibit greater variability, a larger spread, than *mandatory* disclosures. Firms may be assigned a disclosure score based on analyst ratings, such as by the Financial Analysts Federation (FAF), the Association for Investment Management and Research (AIMR, formerly FAF and ICFA), Center for International Financial Analysis and Research (CIFAR) and S&P (see, e.g., Lang and Lundholm, 1993; Lundholm and Myers, 2002). A subcategory of analyst-based disclosure scores is annual report 'beauty contests' or awards. Papers using these measures often make a claim to being objective in that the researcher's own views or interests or perceptions cannot influence the results. Their coverage of both annual reports, interim reports and other investor relation publications also make them highly useful as proxies for overall, or total, transparency. However, FAF reports, for instance, relate to analysts' perceptions about the informativeness of communication, not actual disclosures. As such, they are inevitably subjective, and often only capture disclosure quality indirectly.

To achieve a more direct way of measuring disclosure, many researchers instead use self-constructed indexes. Botosan (1997) constructed a 20-item index that has since been replicated and extended, or used as a point of departure (see Francis et al., 2008; Jiang et al., 2011; Webb et al., 2008). Note, however, that although these may be more transparent, they are by no means *objective*, since the choice of what goes into the index is made by the researcher himself—it may even be considered a more subjective method. These largely overlapping indexes tend to have a list of disclosure items which earn the firm a score upon inclusion, where most often a binary scale is used per item. Typical disclosure items pertain to descriptive information about the business (goals, objectives, strategies, competition, principal products and markets), quantitative or financial data (profitability ratios, multiple-period summaries of sales and net income), key non-financial statistics (employee information, order backlog, units sold and market share), forecasts (of profit, sales, cash flows and market share) and other management discussions (of changes in accounting items, such as sales, cost of goods sold, sales and administration, inventory, accounts receivable and interest expenses). The index in Luo et al. (2006), used also by Cheng and Courtenay (2006), is constructed by referring to prior literature, an annual report award and 'the report of business reporting research project by FASB (2001)"; the authors thus arrive at 82 discretionary disclosure items.

Essay 1 is inspired by all the above studies. We recognize that quantity is not quality, and claim that higher disclosure scores have no quality implications if they are driven by factors that are not related to the firm's underlying economics. In this spirit, we also distinguish between 'substantive' and 'non-substantive' disclosures.

5.3 Essay 2

Capital market effects of corporate information are the focus of Essay 2. It relies on event study methodologies in studying the link between abnormal returns and the recognition of previously unrecognized pension-related actuarial losses (see the essay itself for a closer description of these losses). More specifically, IAS 19 *Employee Benefits* previously allowed *unrealized* losses (and gains) relating to certain pension liabilities to be accounted for in a number of different ways; it was possible to choose whether to recognize the gains and/or losses in net income, leave them out of the balance sheet and income statement completely (indefinitely or through deferral) and simply disclose information about them in the supplementary notes, or recognize them in other comprehensive income (OCI). Recent amendments to IAS 19 only allow the latter method.

The changes to the standard concern how the losses should be presented, *not measured*. No 'substantial' or apparently value-altering changes have thus taken place—other than to how the information is displayed. Essay 2 attempts to inform the debate on presentation format by looking at a how these pension items, which were previously recorded off-balance-sheet, are received by the market when they appear as other comprehensive income instead, and what the one-time, transitional effect on returns is when the change in treatment appears as a restatement in equity. The implicit question asked is how effective a given accounting standard is in facilitating credible communication between managers and outside investors, and whether present standards adequately ensure high-quality accounts.

My findings indicate that short-term abnormal returns are correlated with the presence of unrecognized actuarial losses in the period immediately before IAS 19-related information is released. Early IAS 19 amendment events (the release of the new Exposure Draft and the release of the final, amended standard) show positive reactions for firms with previously unrecognized actuarial losses, indicating that investors perceive there to be a future increase in the reliability—or possibly transparency in general—of those firms' reported numbers. Results also support the hypothesis that disclosures are more complex or less complete than formally recognized items, as firms react negatively upon allegedly discovering previously unrecognized losses, but also positively to the extent that these losses were lower than expected. Based on the main premises of the value relevance and earnings-returns literature, my results allow me to draw conclusions about the usefulness of the numbers before and after the amended IAS 19. Consistent with findings in another recently published study on the placement of gains and losses from early debt extinguishment (Bartov and Mohanram, 2014), investors are not indifferent to the presentation of these actuarial gains and losses; rather, the amended IAS 19 is an improvement in terms of the transparency of said items.

5.4 Essay 3

Essay 3 focuses on the effect on earnings quality that different estimation approaches of credit losses have in banks. The current IFRS standard, with its version of the 'incurred' loss model inspired by US GAAP, is *less* principles-based, letting banks make provisions for credit losses only when a debtor-related loss event has occurred. Meanwhile, local GAAP allow relatively more judgment under versions of the *expected* loss model, as firms are given more leeway to use prior experience in making statistical calculations of expected losses. Based on the fact that the incurred loss approach involves fewer estimations, and thus less timely recognition of losses, we predict that the 'incurred loss' model is detrimental to accounting quality. As discussed in Section 3.3, we recognize that earnings quality is highly context-specific and adapt the earnings quality measure to the bank setting, using as a proxy the *predictive ability* that these provisions have in relation to actual credit losses. Our findings on the 'incurred loss' model versus the 'expected loss' model are consistent with the earnings number better reflecting the underlying economics of the firm in cases where there are more timely loss predictions using judgment. We make a case for the positive aspects of this smoothing effect and suggest an earnings quality measure that avoids the ambiguity of the commonly used smoothness measure. We highlight the fact that banks play an important macro-economic role and that smoothing can be counter-cyclical by requiring earlier loss recognition—something that is advantageous for the economy to the extent that banks are more proactive in taking losses in 'good' times, even when the loss events have not fully materialized. This follows mainly from the fact that the recognition of losses reduces a bank's ability to make new loans, which lowers its risk level through a reduced exposure to future losses.

The results in Essay 3 support the view that principles-based standards are beneficial, at least when considering the positive effect that judgment has on the predictive ability of loan loss provisions in banks. To reiterate, depending on whether the *incurred* loss model or the *expected* loss model is used, different outcomes may be expected. We find that the latter model improves the ability of the provisions to predict actual losses, which we interpret as reflecting superior quality of the provision item. However, consistent with Christensen et al. (2013), we find enforcement to be a prerequisite for quality improvements. Unless national enforcement is high, as measured by proxies developed by Barth et al. (2006), the 'expected loss' model is *not* superior to the 'incurred loss' model. More generally, enforcement plays a particularly strong role when there is more estimation complexity and judgment involved in the measurement of loan loss provisions.

Moreover, we look at the moderating effect of incentives as captured by firm size and profitability. Firm performance is believed to be positively related to

earnings quality, mainly because firms that perform weakly are more likely to understate their loan loss provisions, thus making them less timely, and vice versa for firms that perform well. Therefore, we expect that loan loss provisions are better predictors of actual losses in IFRS banks compared with local GAAP banks when operating profitability is high, but that the relationship is reversed when operating profitability is low. The results are consistent with the former prediction, but not with the latter. More specifically, there is no difference between the groups when profitability is low. We also find that profitability has little impact on the predictive ability on LLP under IFRS, but that a higher profitability improves the predictive ability of LLP under local GAAP. As for firm size, larger firms are expected to enjoy a higher predictive ability of LLP on average, due to the presence of political costs and media monitoring reducing their ability and/or willingness to delay loss recognition. Better systems and internal controls are hypothesized to further improve their ability to make timely and accurate provisions for losses. It is predicted that these tendencies are more pronounced in high-judgment settings, widening the gap between the predictive ability of LLP in large versus small banks. Our findings support these expectations: although large banks are, on average, better at predicting future losses than small banks regardless of the standard used, large banks following local GAAP are relatively better off than large banks following IFRS. This is driven by the greater predictive ability of LLP in large, local GAAP banks. Meanwhile, it cannot be statistically certified that size affects the quality of LLP under IFRS, or that either standard is superior for small banks.

We thus inform the current debate related to the recently published IFRS 9: *Financial Instruments*, and conclude that allowing firms (here: banks) to convey their private information to the market at an earlier stage, is beneficial to the market, even when it requires a greater amount of judgment on behalf of management—but only when there is strong enforcement and banks are large or profitable enough to properly implement the standard. Whether the changes introduced in IFRS 9, compared with IAS 39, are to be seen as favorable is thus highly dependent on circumstances.

5.5 The Licenciate thesis and a follow-up study

The study in Runesson (2010) can be thought of as the source of the essays presented here, in that it embodies all the central ideas of this latter work: accounting and disclosure quality, market reactions, principles-based accounting and judgment. Using association-based tests (see discussion in Section 2.3), I looked at how firms' use of judgment (as revealed by IAS 1 disclosures) affects accounting quality via the value relevance of book values and earnings. Rather than taking the disclosures at 'face value', attempts were made to control for confounding factors, so that the disclosures could be used as proxies for estima-

tion or measurement uncertainty. After decomposing the constructed judgment measure into different line items, I tested their explanatory power on stock market returns and prices. The aim was thus to see whether high estimation difficulties in different items (such as goodwill or property, plant and equipment (PP&E)) had different valuation implications.

Due to suspicions that grew out of the research process, that the disclosures were most likely flawed proxies for true estimation uncertainty, the idea for Essay 1 came about. Also, due largely to the existence of potentially spurious relationships in the types of models used[20], future tests abandoned value relevance setups. A follow-up study that did not make it into Essay 1, but which may serve as a transition to it, is presented next. It is a 'pure' disclosure study that makes no assumptions about reflections of judgment, but links the disclosures to market measures.

To reiterate what has been one of the premises underlying this text: one way of assessing the quality of accounting, or the standard that produces it, is to evaluate it in terms of the level of transparency achieved for capital market actors. A central objective of IFRS, both as expressed by the IASB and by the EU IAS regulation, is better functioning capital markets. That is, financial statements are useful if they can be used for capital market decisions and predicting future returns (cf. the standard-setters' Conceptual Frameworks). This is in agreement with the widely accepted assumption that capital market investors seek to maximize their (risk-adjusted) returns. As regards capital markets, it is possible to study the association between disclosures and different capital market measures. A high association is expected whenever the disclosures affect or reflect market decisions (valuation). Analysts' forecast dispersion is chosen as a proxy for investor uncertainty, with forecast dispersion assumed to decrease with disclosure, as the forecasting activity of analysts is facilitated with the availability of more comprehensive information. Although the common view in the literature is that increased disclosure reduces information risk, leading to increased liquidity and reduced cost of capital (see Chapter 2) as well as a reduction in analysts' forecast dispersion, two aspects of IAS 1 disclosures could lead to a different interpretation of results. First, they constitute a small part of a large package of information (the annual report) that is published with a delay compared to other financial statements (such as the income statement and the balance sheet in quarterly reports). Second, the disclosures are 'negative' in nature, i.e. they provide information about increased information risk. With respect to the former, IAS 1 disclosures are included in annual reports, but are normally not part of quarterly reports. That is, they are provided to the market some time after the provision of more fundamental information such as earnings numbers. Furthermore, the annual report can be up to several hundred pages for a large, listed firm. There is a large amount of information made public si-

[20]See, for instance, a discussion on scale effects by Barth and Clinch (2009).

multaneously with the IAS 1 disclosures, meaning any covariation between the IAS 1 disclosures and other accounting quality aspects (such as a generally high disclosure level and/or high earnings quality) could be what is driving capital market findings. To some extent, both general disclosure level and earnings quality are controlled for, but all pertinent factors may not have been captured. With respect to the second point, about the IAS 1 disclosures studied being 'negative', the fact that they are meant to convey the presence of measurement uncertainties may lead to the disclosed uncertainty having a counteractive effect that nullifies the benefits of transparency. That is, as pointed out by Kim and Park (2009), negative disclosure can have either of two opposite effects on the market; first, they can be positive, in the sense that they decrease information asymmetry about that which is negative; second, they can be negative, in that they provide actual negative news to the market.[21] Depending on which effect is stronger, associations could be in either of the directions suggested above. My findings, that dispersion decreases with more substantive IAS 1 disclosures, are not consistent with the view that the disclosures increase perceived uncertainty by analysts. Rather, one might conclude that any information, whether containing 'good' or 'bad' news, is useful. I dare not assume causality, but results suggest the disclosures are informative and reflective of true uncertainty in the measurement process.

In examining whether firms disclosing according to IAS 1 have differential dispersion among analysts' earnings forecasts, the following general regression model was specified for the cross-section of firms j (where j=1,2...n) as follows:

$$\boldsymbol{Disp} = \boldsymbol{a}\alpha + \boldsymbol{d}\delta + \boldsymbol{U}\boldsymbol{v} + \boldsymbol{I}\boldsymbol{\iota} + \boldsymbol{C}\boldsymbol{\kappa} + \boldsymbol{\epsilon} \tag{1}$$

where

$\boldsymbol{Disp}$ is an $n \times 1$ vector representing analyst forecast dispersion via one of the following market data variables: SDEPS1, SDEPS2, SDEPS3, where these are the standard deviations of 1-, 2- and 3-year forward I/B/E/S estimates, respectively,

$\boldsymbol{a}$ is an $n \times 1$ vector of ones,

α is a scalar representing the regression intercept coefficient,

$\boldsymbol{d}$ is an $n \times 1$ vector of disclosure count index scores (one of $Disc_{\mathrm{S}}$ or $Disc_{\mathrm{NS}}$),

δ is a scalar representing the disclosure index coefficient,

$\boldsymbol{U}$ is an $n \times u$ matrix of u uncertainty/judgment proxy variables, with one column for each of those variables,

[21] Kim and Park (2009) find that although it may be costly to correct internal control deficiencies discovered under SOX, (voluntary) disclosures of these deficiencies are shown to generally reduce investor uncertainty about the firm; and when this is the case, the firm also manages to lower its discount rate and therefore produce a less negative market reaction to the disclosure (as measured by less negative abnormal stock returns). Firms with non-material bad news are better off disclosing them, because 'the benefits of reducing market uncertainty outweigh the costs" of disclosing. This is especially true in cases where investors have suspected weaknesses but have been uncertain about their severity. However, firms with bad news that are *material*, are better off *not* disclosing them, because their negative impact overshadows the benefits of transparency.

$\boldsymbol{\upsilon}$ is an $u \times 1$ parameter vector multiplying the u uncertainty/judgment proxy variables,

$\boldsymbol{I}$ is an $n \times i$ matrix of i incentive variables, with one column for each of the incentive variables,

$\boldsymbol{\iota}$ is a $i \times 1$ parameter vector multiplying the i incentive variables,

$\boldsymbol{C}$ is an $n \times c$ matrix of c contextual factor variables (including time), with one column for each of the contextual factor variables,

$\boldsymbol{\kappa}$ is a $c \times 1$ parameter vector multiplying the c contextual factor variables, and

$\boldsymbol{\epsilon}$ is an $n \times 1$ vector of zero mean disturbance terms.

The data used corresponds to that of Essay 1, as described in Section 5.6 below, after being reduced by missing observations on the market variable. For details on the measurement and definition of the disclosure index and control variables, please see Essay 1. The regression results are shown in Table II. As can be seen, forecast dispersion for 2- and 3-year forward forecasts are lower for firms with more uncertainty disclosures, but only if they are substantive. Non-substantive disclosures have no effect on forecast dispersion. Not only does this give some confidence that the 'substantive' and 'non-substantive' labels are meaningful, there is also information to be found in the principles-based IAS 1 disclosures.

Table II
Analyst forecast dispersion

	Substantive disclosures			Non-substantive disclosures		
	SDEPS1	SDEPS2	SDEPS3	SDEPS1	SDEPS2	SDEPS3
Count index	−0.016	−0.011**	−0.011**	−0.03	0.015	0.016
	(−1.15)	(−3.01)	(−2.68)	(−0.80)	(1.14)	(1.38)
Intercept	−0.513	−0.593**	−0.805***	−1.758	−0.628	−0.943**
	(−0.70)	(−3.21)	(−4.23)	(−1.82)	(−1.96)	(−2.91)
R-sq	0.236	0.222	0.214	0.292	0.286	0.291
N	887	887	887	362	362	362

This table shows regression outputs from regressing the standard deviation of I/B/E/S estimates on disclosure (count) index variables ($Disc_{\mathrm{S}}$ and $Disc_{\mathrm{NS}}$). SDEPS1, SDEPS2, SDEPS3 are the standard deviations of 1-, 2- and 3-year forward I/B/E/S estimates, respectively. All control variables are omitted for the sake of brevity.
*, ** and *** denote p-values of 0.05, 0.01, and 0.001, respectively.

From this market-oriented perspective, we subsequently decided to focus on the determinants of the disclosures separately. Accounting quality, and more specifically principles-based disclosure quality, was thus evaluated in multiple ways.

5.6 Data and research design

All essays employ versions of quantitative approaches to data analysis. Multiple regression of one dependent variable on a number of explanatory variables has been used throughout, with various adaptations being made depending on the

type of variables considered.[22] Essay 1, however, uses an additional technique that so far is relatively unknown in the accounting literature—Classification and Regression Tree (CART) analysis. This is considered appropriate because of the exploratory nature of the essay, and due to the lack of concrete hypotheses (instead we present more general conjectures based on a wide range of theories).

Data for all the main variables considered has been hand-collected via annual reports for the entire sample of firm-years (disclosures in Essay 1, pension data for Essay 2 and information on loan losses for Essay 3). Meanwhile, most of the data used as control variables has been obtained from existing databases, putting the essays in the category of archival studies.

Table III shows the full samples for each essay, broken down by country, industry and year. The sample in Essay 1 constitutes a cross-section of firms, in that each firm only appears once in the sample (2,078 firms are examined at one point in time during the period 2005–2009). Essay 2 uses panel data for 229 firms for 2010–2012, which gives a total of 640 observations (however, because each year is tested separately, the actual tests are to be viewed as cross-sections, and the samples as presented in the essay are for each IAS 19 event/year separately). Essay 3 uses a classic panel data design (data for 645 banks, collected for all available years between 2001–2010, gives a total of 2,398 observations).

Potential weaknesses of the studies are mostly traceable to methodological issues. For example, in Essay 1, our model's ability to explain disclosures lies at around 20% (based on R-squared estimates), implying that there is a 'black box' with respect to firm behavior for the remaining 80% of the variation. Essay 2, meanwhile, uses an event study methodology and is therefore dependent on the 'purity' of the event date for its conclusions. Concurrent events would confound results, as would omitted variables that are systematically related to the tested variables (this is, admittedly, a ubiquitous problem in all types of statistical tests, including those of the other essays). Finally, Essay 3 relies on a proxy for earnings quality derived from Altamuro and Beatty (2010), which, if interpreted differently, may imply different conclusions. More specifically, we assume that, ideally, it should be possible to predict loan losses one to two years in advance. Mostly untabulated tests confirm that looking at three and even four years in advance improves the model further, but if provisions are made five years in advance, this might indicate an even higher degree of quality—something which the model does not capture.[23] In tabulated tests, in fact, it would seem that those firms that make provisions three or more years in advance do not make provisions at all, potentially confounding the results. However, because the explanatory power of provisions steadily decreases for longer lags, we are

[22] Here I refer to, for instance, OLS, Probit and Poisson models.

[23] Data limitations (having three or more consecutive years of data is restrictive and leads to small samples) make it difficult to draw conclusions from longer test-periods, not least because of sample selection issues that may arise if the studied sample is a result of strict data requirements.

Table III
Samples

	Essay 1		Essay 2		Essay 3	
Total # observations	2,078		640		2,398	
Total # unique firms	2,078		229		645	
Country breakdown	N	%	N	%	N	%
Austria	40	2			58	2
Belgium	67	3			30	1
Czech Republic	9	0			58	2
Denmark	76	4	73	11	85	4
Estonia					10	0
Finland	96	5	139	22	22	1
France	252	12			180	8
Germany	334	16			88	4
Greece	75	4			64	3
Hungary	11	1			37	2
Ireland	20	1			50	2
Italy	129	6			920	38
Netherlands	69	3			52	2
Norway	129	6	204	32		
Poland	67	3			93	4
Portugal	22	1			48	2
Romania	1	0			28	1
Slovenia	8	0			32	1
Spain	64	3			127	5
Sweden	179	9	224	35	83	3
Switzerland					91	4
United Kingdom	430	21			242	10
Industry breakdown†	N	%	N	%	N	%
Basic Materials	141	7	56	9		
Consumer Goods	301	14	87	14		
Consumer Services	299	14	36	6		
Health Care	158	8	27	4		
Industrials	662	32	221	35		
Oil & Gas	102	5	68	11		
Technology	320	15	33	5		
Telecommunications	36	2	12	2		
Utilities	59	3	9	1		
Financials			91	14	2,398	100
Year breakdown	N	%	N	%	N	%
2001					20	1
2002					23	1
2003					36	2
2004					83	3
2005	322	15			156	7
2006	426	20			362	15
2007	447	22			414	17
2008	448	22			468	20
2009	435	21			476	20
2010			213	33	360	15
2011			215	34		
2012			212	33		

This table describes the samples used in the three essays, broken down by country, industry and year.

† Industry Classification Benchmark (ICB): 1-digit level

reasonably confident that the described phenomenon is not driving results.

5.7 Conclusions, contributions and suggestions for future research

This thesis investigates quality implications of features pertaining to three different accounting standards: IAS 1 *Presentation of Financial Statements*, IAS 19 *Employee Benefits* and IFRS 9 *Financial Instruments*. The underlying aim is to draw conclusions about effects on accounting usefulness of the various accounting methods and disclosure rules prescribed by these standards. The rationale for this type of research can be derived from the IASB's own requirements that a post-implementation review (PIR) be executed whenever significant financial reporting changes are introduced by a new or revised standard (IASCF, 2008). Reasonable arguments for why academic research 'can, and should' inform such a process are put forward by Ewert and Wagenhofer (2012), which include references to the fact that empirical accounting literature is evidence-based (rather than merely a collection of opinions of a comment letter style).[24] Below, I summarize the evidence from the presented essays.

Essay 1, which focuses on IAS 1, finds that principles-based disclosures are driven by actual, underlying economic conditions, but also by firm-level incentives and monitoring (enforcement). This is explained by their discretionary nature. The legal environment also explains disclosures, which suggests tradition plays an important role in the financial reporting outcome. If 'old habits die hard', accounting quality by means of harmonized rules will not be achieved.

No comprehensive theory of disclosure exists for either voluntary disclosures (Christensen et al., 2010), or mandatory disclosures (Schipper, 2007), which arguably makes it difficult to draw conclusions from empirical research. Schipper (2007) carries out a thorough discussion of mandatory disclosures, raising such important questions as what their purported purpose is, whether this purpose is achieved, and how the disclosures are perceived by the market. As for the purported purpose, the IASB has in its most recent discussion paper on a Conceptual Framework (IASB, 2013b), clarified that:

> The objective of primary financial statements is to provide summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity, and cash flows that has been classified and aggregated in a manner that is useful to users of financial statements in making decisions about providing resources to the entity. ...[T]he objective of the notes to the financial statements is to supplement the primary financial statements by providing additional useful information...

[24] The standard setting process is indeed enlightened by constituents' comments to discussion papers and exposure drafts relating to standard issuances or revisions, but conclusions should arguably not be based solely on these.

Given the described desired purpose, Essay 1 contributes to this literature by providing evidence of how principles-based mandatory disclosures may work in practice and what their determinants are. To my knowledge, Essay 1 is unique in presenting such comprehensive data on disclosures relating to judgment and estimation uncertainty (all available firms in Europe that are affected by the regulation are included in the sample).

Meanwhile, Essay 2 shows that the amended IAS 19, which limits accounting choices relating to actuarial gains and losses and requires formal recognition of previously disclosed items, improves reporting transparency of pension liabilities. Support is provided for the view put forth in the IAS 19 Exposure Draft, that the many accounting choices allowed under the old standard could be 'confusing' or 'misleading', not least when all gains and losses arising in a given period did not affect the reported amounts. The idea behind the changes to IAS 19 is that the new way of accounting for unrealized pension-related gains and losses better reflects the underlying economics, as it reduces undesirable volatility caused by including the items in net income, makes income smoother, and is at the same time a more transparent accounting method than excluding the items from the balance sheet and comprehensive income statement altogether. What it ultimately comes down to, is ensuring a framework and standards that encourage measures and formats that contribute most successfully to the faithful representation of the underlying economics of the firm. Essay 2 is timely in its review of the evidence related to IAS 19 amendments, and contributes to previous American literature on pension accounting under US GAAP. The claim that the disclosure of post-employment benefit obligations (especially related to IAS 19 and its amendments) is of special interest at this point in time, is backed up in the recent report by the European Securities and Markets Authority (ESMA) (ESMA, 2014).

Finally, as the EU contemplates adopting the newly announced standard on financial instruments, IFRS 9, Essay 3 inquires into the potential benefits of the 'expected loss' model as compared with the 'incurred loss' model. IFRS is a largely principles-based framework, but in the area of loan loss provisioning, it has been comparatively strict in its allowance of judgment. We find that loan loss provisioning under IFRS has a lower predictive ability when it comes to actual losses, which we attribute to too-late provisioning behavior brought on by the 'incurred loss' model. Essentially, verifiability takes precedence over expected loss occurrences, delaying the recognition of losses unduly. However and importantly, for the 'expected loss' model to work well, firms must operate in high-enforcement settings and have low incentives to manage earnings. Less profitable firms may be encouraged to make provisions later than is warranted, or not at all. This reduces the ability of provisions to predict actual losses and ultimately lowers the quality of the provisions and bottom-line earnings. Contributions are made to the literature as regards the use of a metric that

focuses on the loss-predicting ability of provisions rather than earnings smoothing, and as regards the combined approach of looking at IFRS, incentives and enforcement in banks.

Findings add to the growing body of literature that studies accounting quality under global accounting standards. Ideally, principles-based accounting standards will improve transparency to the market to the extent that they encourage management to convey private information to users of the accounts. However, managerial incentives and inadequate enforcement remain barriers to the achievement of such a lofty goal.

Suggestions for future research

Accounting standards, disclosures and judgments have been the focus of the present text. In studying these, the concept of information uncertainty has been highlighted to some extent. Future work should proceed along these lines and further identify the role that information uncertainty plays in the market, and what determines this uncertainty—with a distinction between information uncertainty and information asymmetry being maintained and clarified at all times. To date, there has been little investigation of the phenomena of information overload and of boilerplate disclosures, and the effect of these on accounting users. One may, in this context, ask how *readability* is affected by these phenomena, and if readability has any economic consequences (in terms of, e.g., changes in cost of capital). If readability is a proxy for understandability and relevance, it is reasonable to believe transparency may be affected. If there is a comparatively greater post-earnings announcement drift (PEAD) following firms' releases of reports characterized by lower readability or understandability due to excessive disclosures, this could mean that investor uncertainty is higher. Readability as a determinant of market outcomes is largely unexplored, although some early evidence has been provided (Lee, 2012; Rennekamp, 2012; Tan et al., 2014). The fact that the form of financial disclosures can have market effects is something that has been explored previously, not least in the present thesis. *Language* in so-called 'narrative' disclosures is a subset of *form* and may also play a part in determining market outcomes (Davis and Tama-Sweet, 2012; Hales et al., 2011). Linguistic methods may therefore be of use in finding out the role that language, in particular, has on readability.

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Essay 1

Essay 2

Essay 3