THE VIEW FROM ACADEME: ACCOUNTING AND FINANCIAL REPORTING

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THE OBSERVER EFFECT IN ACCOUNTING:

What you measure changes corporate strategy

BY MARTY DAKS | MAY 06, 2015

In physics, the well-known observer effect describes how the act of measurement changes what's being measured. An electron can't be detected without interacting with a photon, yet that interaction changes the path of the electron.

Similarly, in accounting, recent research suggests that the way we measure and report companies' business transactions will significantly change those companies' strategies, argue Chandra Kanodia of the University of Minnesota and Haresh Sapra of Chicago Booth. If that's true, they suggest, then accounting disclosures that incrementally inform investors may not necessarily help companies make better decisions in allocating resources.

In a paper to be presented this week at the Journal of Accounting Research conference, the researchers synthesize the methodology of some of these recent "real effects" studies. They suggest that accounting standard-setters should question the popular belief that accounting provides information on an objective reality, independent of accounting measurements and disclosure. They argue that researchers and policymakers should shift away from seeking correlations between increased disclosure and improved security returns, and instead focus on the "identification and empirical detection of real effects."

In the traditional view, corporate managers make decisions solely based on the information they possess. Better information means the managers make better decisions, and shareholders get a higher payoff. But this one-way model doesn't incorporate how an awareness of shareholders' desire for larger returns affects managers' choices. Managers' decisions "must necessarily be affected by the information in the capital market," the researchers argue.

Consider, for example, how accounting disclosures about a company's expenses can affect shareholders. Currently, investment expenditures are generally recorded on the balance sheet as assets, and are expensed against future revenue through depreciation and amortization. Operating expenses, meanwhile, are matched with current revenue to determine the current-period profit or loss for a firm. But a company's investment cannot be directly observed by outsiders and, in practice, it is difficult to measure. Further, although a firm's cash outflows are readily visible, those

aggregate outflows do not make it clear how much is investment and how much is operating expense. This measurement noise affects investors' views on the company, which, in turn, influence managers' decision-making.

Building on previous research, Kanodia and Sapra construct a detailed model of how measurement noise affects a firm's investment choices. They note that cash-flow accounting methods filter out the noise in accrual accounting measurements, so cash flow becomes more informative to investors whenever accruals are noisy. Conversely, accrual accounting becomes more informative when cash flows are noisy. The implication is that cash flow and accounting income will be used to update investor assessments of the firms' future cash flows, the researchers add, noting that this claim is consistent with previous findings. This is significant, since research implies that the market's feedback regarding firm performance will influence the firm's investment strategy, for better or for worse. For example, note Kanodia and Sapra, market inferences based on a firm's earnings report tend to have a beneficial effect on the firm's investment, while market inferences based on a firm's net cash flow detract from investment efficiency. So when investment is measured more accurately, the firm's investment is likely to in fact be better.

The researchers aren't about to completely throw accounting standards overboard, but they argue that measurement and reporting systems for stewardship purposes are best left to the discretion of the boards of individual firms. "Accounting standards are intended to govern only the mandatory disclosures that are made to the public at large, including the firm's current stakeholders and also all potential stakeholders," Kanodia and Sapra note. "The value of such large scale public disclosure depends upon having a 'shared' language, which in turn requires the kind of uniform measurements that are enshrined in accounting standards." But they suggest that accounting standard-setters who ignore the real effects being studied will likely produce many unintended consequences.

Works cited: Chandra Kanodia and Haresh Sapra, "A Real Effects Perspective to Accounting Measurement: Implications and Insights for Future Research," Working paper, March 2015.

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IN FINANCIAL REPORTING, LESS IS MORE

BY FRANCINE MCKENNA | JUN 20, 2014

Investors demanded more transparency and accountability after Enron-era accounting frauds, but they weren't totally reassured by new annual and quarterly reporting mandates. That impatience has translated into constant pressure on public company executives to provide frequent earnings guidance and to report positive results as often as possible.

But is too-frequent reporting negatively affecting long-term investor returns? That's the contention explored in a working paper by Chicago Booth Professor Haresh Sapra and colleagues from the University of Illinois at Urbana-Champaign and the University of Minnesota. The authors conclude there's a happy medium between not enough disclosure and too much information delivered too often.

"Since markets are forward looking, any actions that favor the short term at the expense of greater long-term value creation would be effectively punished by lower capital market prices," according to the paper's authors. Overreporting can be costly and may end up a self-fulfilling prophecy, magnifying the attraction to do anything to produce quick profits. "Such pressures disappear when reporting frequency is decreased," the authors report.

Sapra and his colleagues cite anecdotal evidence along with empirical evidence they produced with a model that uses probability theory to analyze real cash flow returns to an investment by a publicly traded firm.

Under the model, an investment decision is made under one of two conditions: good or bad. An executive chooses to invest after getting a signal, a particular piece of information such as a change in business conditions that helps him or her decide whether to make the investment and what type of investment to make. The researchers' results show that long-term projects consistently have a higher present value of expected future cash flows (generally assuming a dollar today is worth more than a dollar tomorrow).

A short-term project often looks attractive because it has a higher probability of producing larger cash flows in early years but that advantage diminishes over time. In other words, short-term investments that flatter the bottom line may appear beneficial, but in the long term they add less to shareholder value.

The authors show long-term projects decisively beat short-term projects in the long term under both good and bad investment conditions.

So how does this impact the way publicly traded companies decide to report? Should companies be reporting any more than is absolutely required, given the feedback loop and short-termism that develops?

The research shows that the more frequently companies report, the more investors expect to see positive results. The split between long-term investors and those looking for early cash flows is constantly changing in large public companies, and executives can't please everyone all of the time.

The research conclusion: investors' short attention spans hurt long-term returns when company executives react to the clamor for short-term results by reporting too frequently and then attempting to meet heightened expectations by any means possible.

Work cited: Frank Gigler, Chandra Kanodia, Haresh Sapra, and Raghu Venugopalan, "How Frequent Financial Reporting Causes Managerial Short-Termism: An Analysis of the Costs and Benefits of Reporting Frequency," Working paper, April 2013.

What is short-termism?

The term refers to an excessive focus on short-term results at the expense of long-term interests. When discussing the causes of the financial crisis, a related term was used by columnist Eric Dash of the *New York Times*: the I-B-G-Y-B-G syndrome, "I'll be gone; you'll be gone" before anyone will have to answer for the toxic mortgage securities building up on bank balance sheets.

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CFO INNOVATION QUESTEX

WHY IT DOESN'T MAKE SENSE TO FORCE FINANCIAL REPORTING REFORM

BY MARTY DAKS | NOV 23, 2015

As part of the attempt to equalize the flow of information between corporate managers and other insiders, and investors and other outsiders, the European Union (EU) and more than 100 other countries require or permit the adoption of harmonized International Financial Reporting Standards (IFRS), or a local version of them.

But accounting quality does not necessarily improve with adopt them, according to research by Chicago Booth's Hans B. Christensen, with Edward Lee, Martin Walker, and Cheng Zeng, all of Manchester Business School.

The researchers analyzed financial reporting improvements, or the lack of improvement, among more than 400 firms in Germany—a country that initially gave companies the option to adopt IFRS on a voluntary basis and subsequently mandated adoption.

This setting let the researchers test whether accounting quality—earnings management, timely loss recognition, and value relevance (how well financial statements capture and summarize a firm's worth)—actually improved when firms were forced to comply with higher-quality accounting standards.

Consistent with existing literature, they found that voluntary adoption of IFRS was associated with decreased earnings management, increased timely loss recognition, and increased value relevance. But they also discovered that these improvements were not found among so-called resister firms that chose not to voluntarily adopt IFRS but eventually were forced to adopt IFRS by the mandate. The "resisters" in the sample tended to have close relationships with banks and other insiders, and were not under much pressure to provide a lot of information to capital markets.

Currently regulators in the United States, Japan, India, Russia, Malaysia, and Colombia are considering mandating IFRS adoption, but that may not yield higher accounting quality among firms that have no incentives to do so.

The researchers found that financial reporting incentives influence accounting quality, despite the many potential benefits from international accounting harmonization under IFRS.

Work cited: *Hans B. Christensen, Edward Lee, Martin Walker, and Cheng Zeng, "Incentives or Standards: What Determines Accounting Quality Changes Around IFRS Adoption?" European Accounting Review, forthcoming.*