



LMU Munich School of Management

Institute for Accounting, Auditing and Analysis

‘Real effects’ of financial reporting regulation: Research opportunities

Prof. Dr. Thorsten Sellhorn

sellhorn@bwl.lmu.de

**VIII FINANCIAL REPORTING WORKSHOP –
University of Parma**

Parma, 22 June 2017



My questions for today's talk

- **What are ,real effects' – and why are they worth studying?**
- What do we already know about ,real effects'?
- What are some research opportunities in the ,real effects' area?

(At the end: Introducing the EAA's new Accounting Research Center)

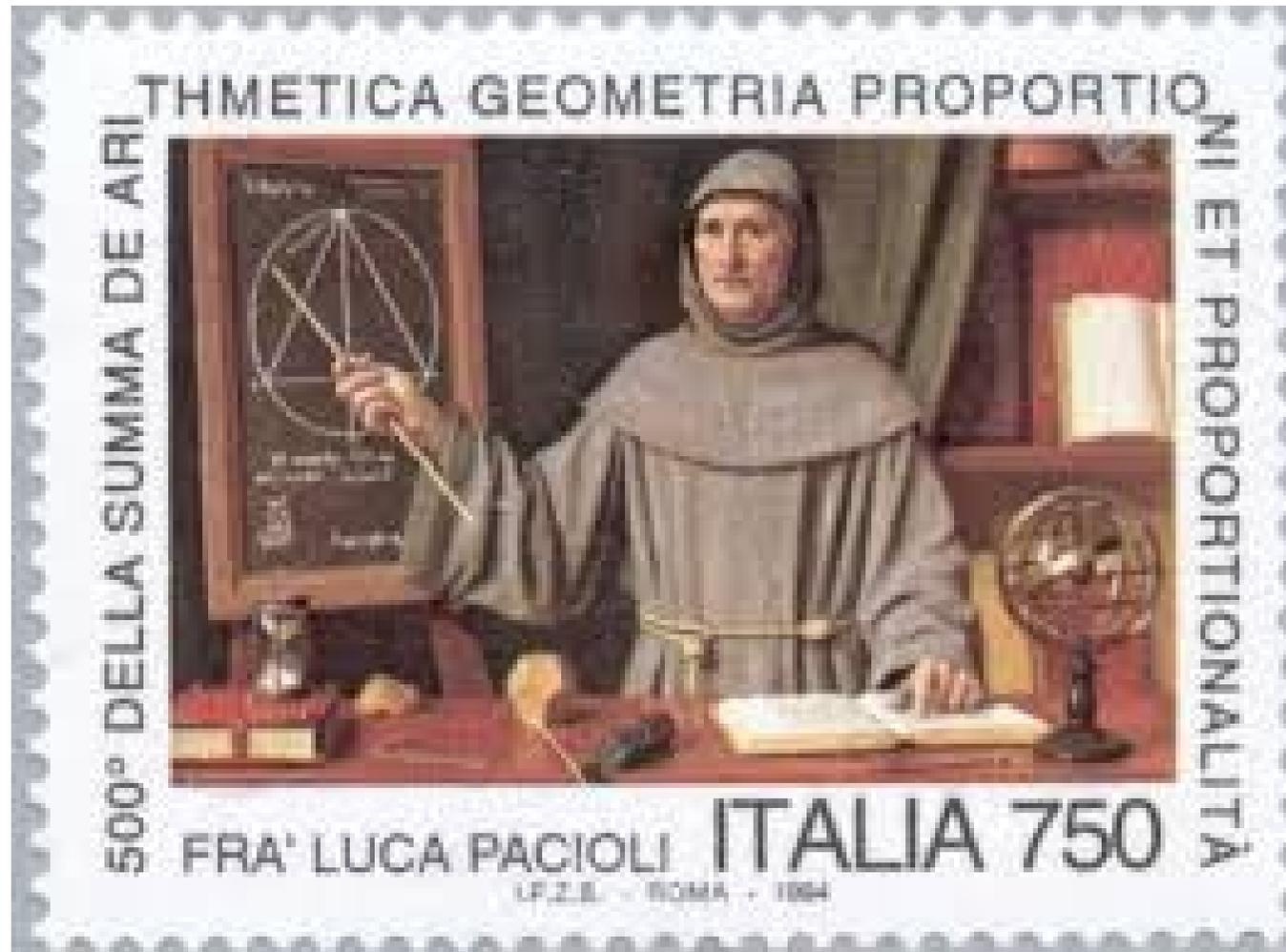
„Real effects“?



„Real effects“?



„Real effects“?



Real effects defined

» We define real effects as situations in which the **disclosing manager or reporting entity changes its behavior in the real economy** (e.g., investment, use of resources, consumption).

Leuz and Wysocki (2016: 545) «

» We define “real effects” as situations in which the disclosing person or reporting entity changes its allocation of resources **as a result of the disclosure mandate**.

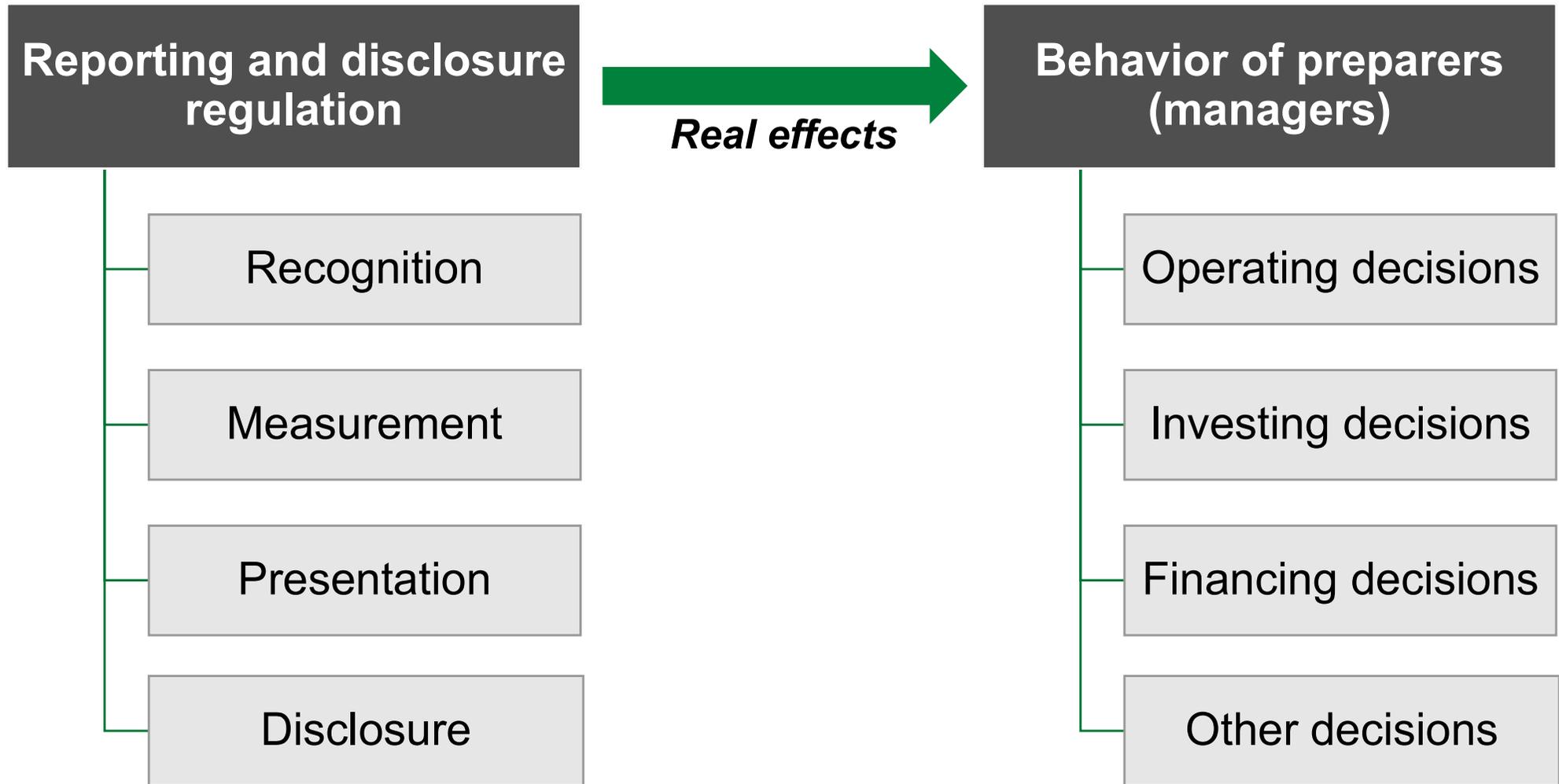
Christensen, Floyd, Liu and Maffett (2017: 1) «

» The real effects hypothesis states that the **measurement and disclosure rules** that govern the functioning of accounting systems—which economic transactions are measured and which are not measured, how they are measured and aggregated, what is disclosed to capital markets and how frequently such disclosures are made—have significant effects on the real decisions that firms make.

Kanodia and Sapra (2016: 545) «

» Concept goes back at least to **Zeff’s (1978) economic consequences** idea

Placing and categorizing real effects: Overview



Placing and categorizing real effects: Other aspects

■ Intended versus unintended effects

- Real effects intended by regulators/legislators (e.g., curbing managerial myopia)
 - Explicitly
 - Implicitly
- Real effects as unintended ‚side effects‘
 - New IFRSs such as IFRS 16 *Leases*
 - Repercussions of IFRS adoption on firms‘ dividend policies
 - (Alleged) procyclical effects of fair value measurement leading up to the financial crisis

■ Disclosure regulation as an alternative to more direct (‚command and control‘) regulation of behavior?

- Effective?
- Efficient?

Why study real effects?



Overall, there is **relatively sparse empirical evidence** on real effects of disclosure and reporting activities.

However, the analytical literature suggests that real effects should be fairly common (see Kanodia and Saprà [2016]). Thus, **we need more empirical research on the prevalence and magnitude of real effects.**

... real-effects studies are **of particular relevance** because the notion that mandating disclosure **induces desirable and/or discourages undesirable behavior** by the disclosing party is an important motivation for transparency regulation in many areas, including corporate governance, consumer protection, health care, and food safety.

The underlying idea of such regulation is to **control behavior through “prices”** (which respond to disclosure), rather than by directly stipulating “quantities” (of the behavior in question). However, there is still **relatively little empirical evidence that speaks to this regulatory motivation.**

Leuz and Wysocki (2016: 550, 578)



Why study real effects? (cont'd)

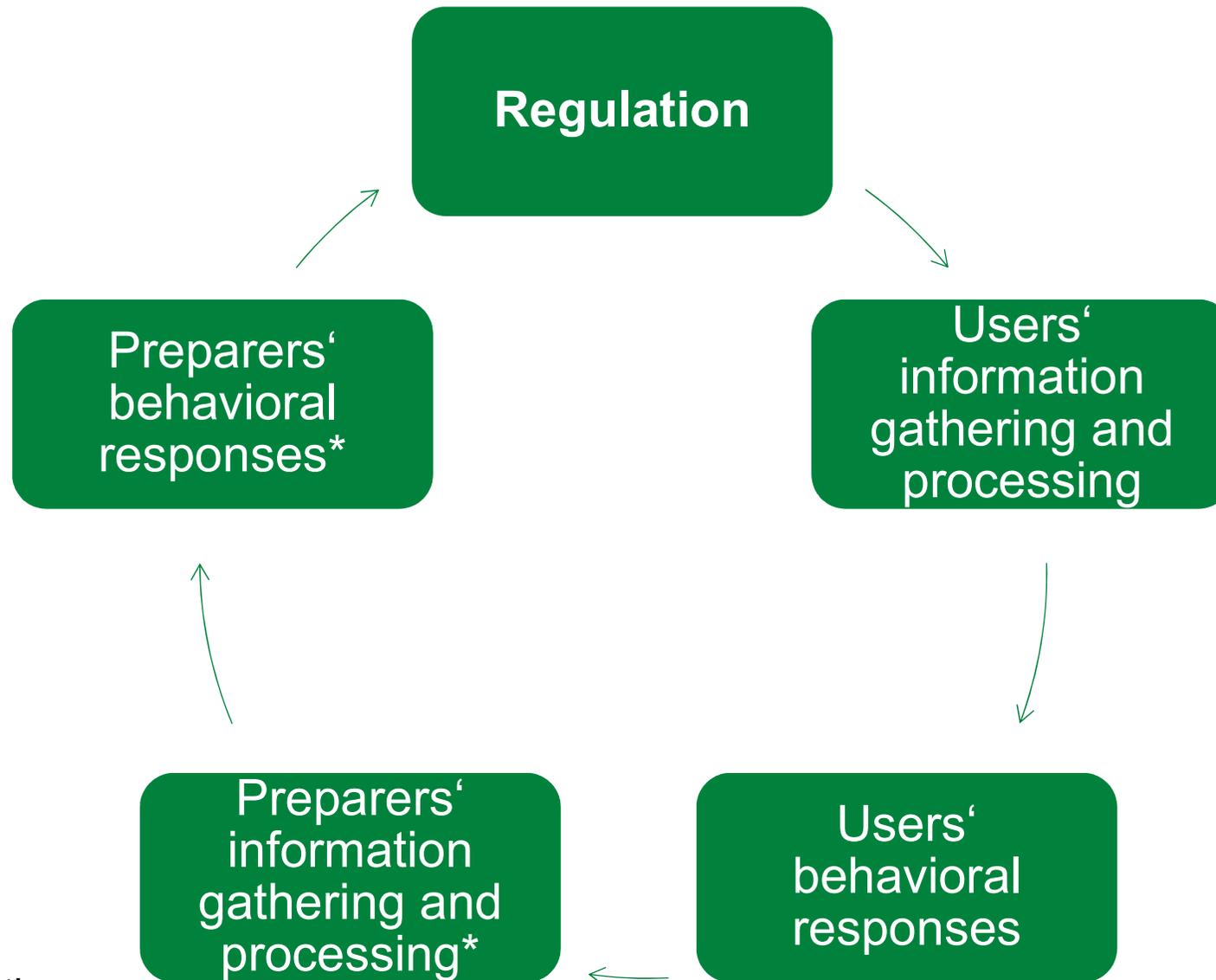
- Opportunity for accounting researchers to **broaden the relevance of accounting research** to society – and to **contribute their expertise „where it matters“**
 - „As societies extend the scope of disclosure and transparency regulation beyond financial reporting, understanding the real effects of such regulation is of first-order importance and a topic to which accounting researchers can contribute significantly.” (Leuz and Wysocki 2016: 602)
 - Just a few examples (more to follow):
 - “Do accounting standards drive R&D investment?”
 - „Does Integrated Reporting foster ,integrated thinking/management‘?”

- Journal editors are taking an **active interest** in these issues – witness the proliferation of real effects studies in JAR

My questions for today's talk

- What are ,real effects' – and why are they worth studying?
- **What do we already know about ,real effects'?**
- What are some research opportunities in the ,real effects' area?

A theory of real effects?



* and/or anticipation

A theory of real effects? – Looking more closely

- At present, there is **no unified theory**—or even sufficiently established standard nomenclature
- For all we know, real effects could operate through several **mechanisms/channels**:
 - Enhanced information allows stakeholders to **better monitor management** (e.g., Grewal et al. 2015; Christensen 2016)
 - “What gets measured gets managed”
 - „Social pressure theory” (Gramlich and Huang 2017)
 - Enhanced information allows managers to make **better decisions** (e.g., Bushman and Smith 2011; McNichols and Stubben 2008)
 - Managers **anticipate the market (i.e., stock price) reactions** to their accounting and disclosure decisions (Kanodia and Sapiro 2016)
 - „Feedback effects“ on management’s real actions (Christensen et al. 2016: 2)
 - New reporting requirements can have **contracting effects**
 - For example: If covenants in debt contracts are based on “rolling GAAP”, changes in GAAP may increase or decrease covenant slack and change firms’ financing decisions (e.g., Shroff 2016)

Some empirical findings

■ Operating decisions

- Environmental outcomes: Pollution levels (Gramlich and Huang 2017)
- Consumer protection: Product quality/hygiene in restaurants (Jin and Leslie 2003)
- Corporate social responsibility (CSR) outcomes (Grewal, Riedl and Serafeim 2015)
- Employee safety in mining (Christensen, Floyd, Liu and Maffett 2017)
- Research and development (R&D) expenditures (Müller and Sellhorn 2013)
- Managerial myopia: Ernstberger, Link, Stich and Vogler (forthcoming)

■ Investment decisions

- Investment efficiency: Broad literature (e.g., Biddle, Hilary, and Verdi 2009)
- Pension asset allocations (e.g., Barthelme, Kiosse and Sellhorn 2017)

■ Avoidance behavior

- Going dark after SOX (Leuz, Triantis, and Wang 2008)
- Going private after SOX (Engel, Hayes, and Wang 2007)

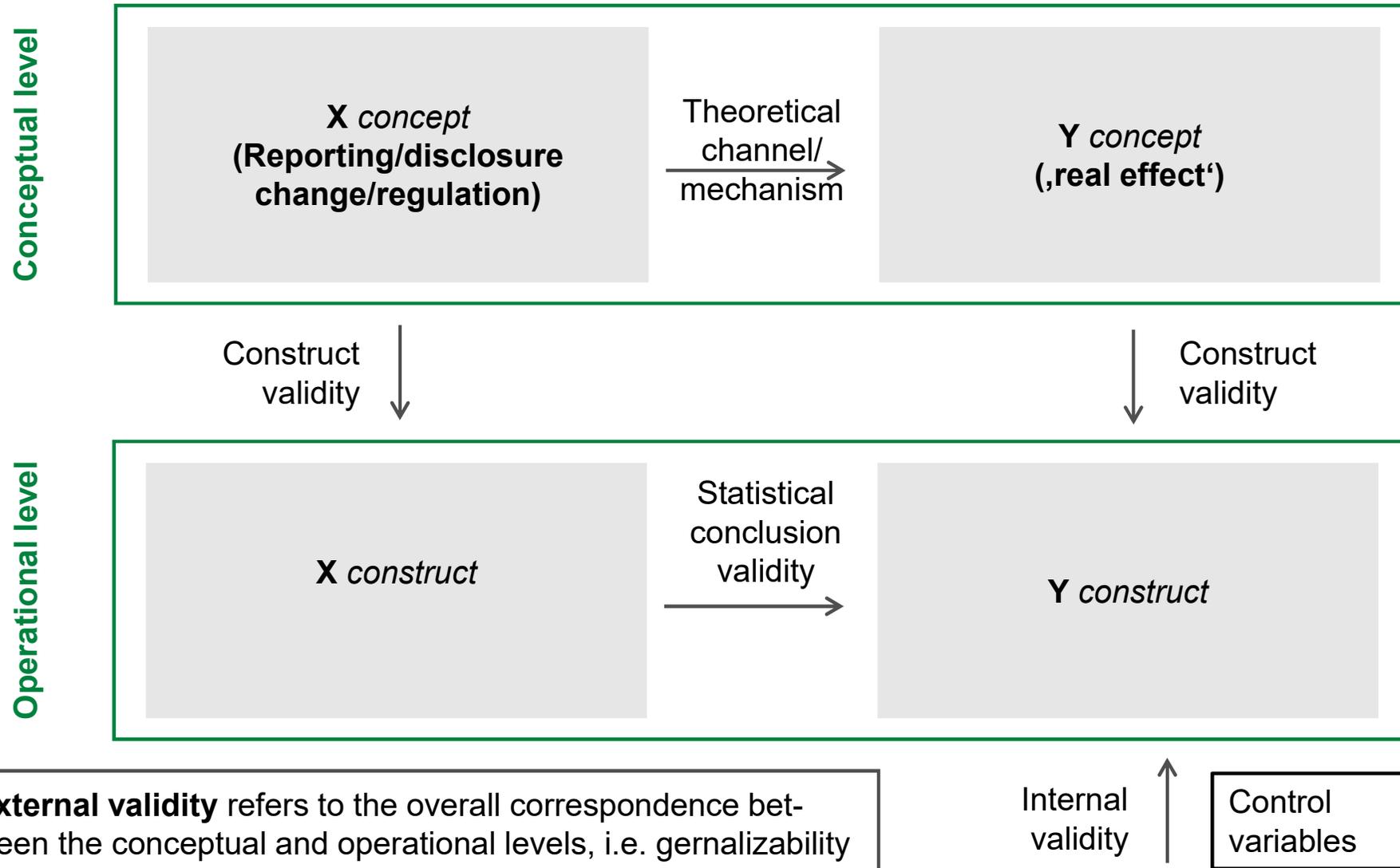
■ Discretionary reporting decisions

- Ernstberger, Pellens, Schmidt and Sellhorn (2017) analyze whether managers temper the „extremeness“ of their reporting decisions where auditors provide greater transparency

My questions for today's talk

- What are ,real effects' – and why are they worth studying?
- What do we already know about ,real effects'?
- **What are some research opportunities in the ,real effects' area?**

„Ingredients“ of a real-effects study (Libby boxes; Libby 1976)



Opportunities in this literature – a Libby boxes approach

▪ Theoretical underpinnings

- Consider new **theoretical channels** / disentangle between existing channels
- Hombach and Sellhorn (2017): New disclosures facilitating NGOs' activism against firms

▪ Internal validity

- Use **new settings** with better causal identification (including to ,replicate' established studies)
- Use **field data** to:
 - Enhance understanding of channels/mechanisms
 - Support causal inference

▪ Construct validity

- Better **measurement** of disclosure phenomena and outcomes

▪ External validity

- Maintaining an **accounting/reporting/disclosure angle** (competitive advantage)
 - Christensen Liu and Maffett (2016): Inclusion in SEC filings
- Analyze **new reporting aspects**
 - Müller, Riedl, Sellhorn and Stier (2017): measurement (historical cost vs fair value)

Making accounting research matter for public policy debates

- Can accounting/disclosure regulation help achieve **public-policy objectives**?
 - For example, foster innovation through R&D accounting?
- Is disclosure regulation more/less effective/efficient than **direct regulation**?
 - Cost-benefit analyses
- Tight identification (internal validity) a necessary condition for **quantification** of effects

Thanks – and good luck with your research!



Schmalenbach Business Review &
Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung

Call for Papers for SBR & ZfbF Special Issues:

Regulation of Corporate Disclosure

Editors:

Willem Buijink (Open University Heerlen, and Tilburg University)

Thorsten Sellhorn (Ludwig-Maximilians-University Munich)

Alfred Wagenhofer (University of Graz)

Submission deadline: 30 November 2017

**Focus on
real effects**

The EAA's new Accounting Research Center: A web-based interactive platform to support accounting researchers

