

Financial Reporting



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SUGGESTIONS FOR FUTURE RESEARCH IN FINANCIAL ACCOUNTING AND AUDITING

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Research in financial accounting



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Financial and management accounting are the main topics chosen by Italian researchers among Accounting Topics with the highest percentage of publications (nearly 70%) (Azzali-Fornaciari-Mazza, 2017WP), followed by social, environmental, integrated reporting (nearly 18%), accounting history (nearly 4%), auditing (nearly 5%), accounting education (nearly 2%), information system (nearly 1%).

Financial accounting is one of the most relevant area of research of Italian authors and publications are related to traditional (for example book keeping, financial reporting, consolidated financial statement, measurement criteria, income and equity evaluation, and taxation) and innovative topics (for example, studies related to earnings quality, earnings management, conservatism, value relevance, effects of IFRS adoption, disclosure).



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Earning and Audit Quality

“Earning quality” and “audit quality” are significant keys words that drive the modern research in accounting and auditing. For examples Dechow P., Weili G., Schrand C., 2010, analyse proxies for earning quality based on:

- a) earning properties (earning persistence, abnormal accruals and modelling the accrual process, earning smoothness, asymmetric timeliness and timely loss recognition, target beating);
- b) investor responsiveness to earnings (direct and indirect evidence of earning response, relations with non-earning information);
- c) external indicators of earning misstatements (firms subject to enforcements, restatement and Internal control weaknesses).

Next, they analyse the determinants (firm characteristics, financial reporting practices, governance and controls, auditors, capital market incentives) and consequences of earning quality based on a review of nearly 300 papers published on high ranked journals. Finally they suggest the main areas of research that have received relatively little attention.

The link with the IASB Framework



An alternative or complementary way to develop research in Financial accounting and auditing is to follow the main Financial Reporting Frameworks suggested by the International Accounting Standard Board (IASB) or by other national standard setter (for example the U.S. FASB, the Italian OIC)

The IASB Framework, after the revision of 2010, could be an useful instrument to drive future research in Financial Accounting and Auditing (Table 3)

The main objective of Financial Reporting (to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity) could be similar to the purpose of research for the measurement of "Earning Quality" (Azzali, 2012)

Table 3 – Link between IASB CF and Accounting Studies on Capital Market

EARNING QUALITY =
Useful information for investors

Faithful representation

Relevance

AUDIT
QUALITY

EARNING
MANAGEMENT

VALUE
RELEVANCE

Relevance and Faithful representation



Useful Financial Reporting information for investors in making economic decision could be interpreted as the way proposed by IASB to achieve the earning quality.

The earning quality could depends on two fundamental qualities (relevance and faithful representation of Financial Reporting information) that characterize the new version of IASB Framework:

- **Relevance** is the capability of financial information to make a difference in the decisions made by investors. “Financial information is capable of making a difference in decision if it has predictive value, confirmatory value or both”. IASB, Conceptual Framework for Financial Reporting, QC7, 2010.
- **Faithful representation**. Previous Framework included “reliability” while the new version identifies the Faithful representation as a wider concept that include completeness, neutrality and information-free from bias.

Value relevance



“Value Relevance” (VR) studies are an important area of Accounting Studies on Capital Market and are directly related to the notion of Relevance as proposed by the IASB Conceptual Framework. VR studies aim to verify the link between accounting numbers and market value and demonstrate (with an assessment of the earning quality or of other Financial Reporting information) the usefulness of financial information for investors. Event or association studies, VR compared along time, among different countries or set of accounting principles are kind of VR studies developed all around the world, with different methods, models, instruments, samples, observations but with a common general objective: to measure the earning quality with the degree of VR between accounting numbers and market value of the companies.

Earning Management



- Faithful representation could be linked with two main areas of research in Financial Reporting studies: 1) Earning Management; 2) Audit Quality:
- “Earning Management” (EM) is one of the most developed topics in Financial Reporting studies. The link with the IASB Conceptual Framework is Neutrality of Financial Reporting information: EM shows the different ways that managers employ to exercise the discretionary judgment in the Financial Reporting process and is negatively related to neutrality of information. EM is exactly the opposite of neutrality even if neutrality does not mean total absence of EM: Financial Reporting are usually characterized by a degree of EM and neutrality demands the disclosure of EM practices to users. EM includes many classes of practices that may be classified for objectives (Earning Smoothing, Conservatism, Analyst expectations, etc.) and for instruments (Accruals divided in Discretionary and not Discretionary, Real EM, etc.).

Audit Quality



- The “Audit Quality” (AQ) is an important area of Financial Accounting Research directly related to Earning Quality and to the usefulness of Financial Reporting information for investors through the Qualitative Characteristic “Free from bias” (ex reliability) and “completeness”. Within AQ we can classify External AQ (EAQ) and Internal AQ (IAQ) studies: both are directly related to reliability but the instruments that researchers employ to study the degree of association are different:
 - Audit opinion, audit fee, audit firms and partners, audit sanctions are significant examples of instruments used in EAQ (Defond and Zhang, 2014);
 - Significant Deficiencies (SD), Material Weaknesses (MW) or the Audit Cycle Phases (ACP) are the main instruments employed in IAQ.
- Finally, a way to study the completeness may be represented by all the researches that aim to measure the compliance of Financial Reporting with the accounting standards and with the required degree of disclosure in the accounting schemes, in the notes, and by investors or other relevant stakeholder.

Examples of research on audit quality



1. Audit Partner Tenure Horizon and Earnings Quality: Evidence from a Dual-Rotation Regime
2. The association between Big4 and Cost of Debt in private firms, Financial Reporting 1, 2017, pp. 81-100.
3. Is Combined Assurance associated with Internal Audit quality and earning management?
4. Does Mandatory IFRS Adoption Affect Audit Effort and Its Effectiveness to Constrain Earnings Management? Evidence from Italy?
5. Effects of Auditor Industry Expertise on Audit Fees and Hours: evidences from Mandatory Audit Firm Rotation setting
6. Determinants of Audit Sanctions: evidences from Italy and Spain

Conclusion



1. IASB Framework could be useful for the research in Financial Accounting because link the main topics (value relevance, earning management and audit quality) in a unique model.
2. The strong emphasis on methodological issues and empirical data that drive most of researches in financial accounting could improve the specialization and quality of the research in term of motivation, contribution to literature and practice.
3. However, Financial accounting is strictly connected with organization and management topics because all related to entities that need to be theorized in an integrated and complementary way, taking into account of different companies (private vs public), governance (family firm or public companies), institutional settings.

References



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5. IASB, Conceptual Framework for Financial Reporting, 2010.