

Collected Abstracts: Research Forum Sessions

FIN

Financial Accounting (capital markets)

Code: **FIN R01**
Abstract ID: **0300**

Day: **Thursday**
Time: **16.00-17.30**
Room: **Q117**

The Market Pricing of Comprehensive Accounting Earnings

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This study investigates the market pricing of comprehensive accounting earnings in the Netherlands for the period of 1988 to 1997. At that time, a large number of dirty surplus accounting flows were allowed, this makes the Netherlands an interesting setting to investigate whether the Dutch investors can price them correctly. Experimental research provides evidence that the public could encounter difficulties in extracting value relevant information if comprehensive accounting earnings were disclosed in the footnote to financial statement (Hirst and Hopkins 1998, and Maines and McDaniel 2000). I gather market data from Datastream for the whole population of Dutch listed firms and accounting information from firms' financial statements. To test the capital market impact of footnote disclosure, this study focuses on two research questions: do the market price currency translation differences, goodwill write-offs, and asset revaluations appropriately; and does the market price comprehensive earnings appropriately? The Mishkin test (1983) is used to assess the market pricing of comprehensive accounting information (Sloan 1996, Xie 2001, and Burgstahler et al. 2002). Consistent with previous research, the market can price reported net income correctly. However, it seems that the market under-estimate the persistence of foreign currency translation differences, asset revaluations, and comprehensive accounting earnings. The results are robust when using a portfolio test.

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The determinants of the decrease in the value relevance of accounting numbers in Portugal

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The purpose of this paper is to analyze the level and identify the determinants of the decrease in the value relevance of accounting numbers in Portugal in period immediately before adoption of IASB normative. In a first stage (i) we identified the association level between the accounting information and market performances and (ii) we analyzed the evolution of these association levels. In a second stage (iii) we search for the reasons of the value relevance decrease. Our sample includes all non-financial companies listed on the Portuguese Stock Market over the period 1988-2003. We used the two methodologies derived from Ohlson construction of regression accounting information in market performances: (i) the price model and (ii) the return model. The models are based on 15 months observation windows. Our results show that (i) Portuguese accounting information is significantly related to market security performances, although to a lesser extent than in countries with more sophisticated markets and accountings systems (ii) there has been a decline in accounting relevance in Portugal during the period 1988-2003 and (iii) the two main factors that contribute to negative evolution of Portuguese accounting information relevance are the change in the business environment, measured by the growth of TMTs (technological, media and telecommunications) firms, and the increase weight of companies with negative earnings.

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The risk premium category under the assumption of capital's energetics nature; the case of banking sector in Poland for the years 1991-2003

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The right risk premium estimation seems to be positioned in the most crucial, however still remaining unsolved, accounting and finance issues. There has been many proposals of how to assess the true value of risk premium of the specific part of economic activity. In this paper author gives a proposition of how to assess the size of risk premium on the basis of ROE index taking into account the energetic nature of capital. The banking sector of Poland in the years 1991-2003 has been taken into consideration for the purposes of calculations. Data from banks listed on the Warsaw Stock Exchange has been used for estimation process.

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Financial strength ratings determinants evolution: Changes, tendency and robustness. An analysis of European insurers facing Basel II and Solvency II

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Financial strength ratings have traditionally been employed by financial institutions for measuring the credit risk of corporations. Recently, Basel II and Solvency II regulations have emphasized even more to use ratings for risk management, such that they allow the design of internal rating-based (IRB) models. Also, supervisory authorities are stimulated to use external ratings for detecting solvency problems. However, the ratings usefulness depends of their determinants knowledge, but rating agencies only provide some general information about the determinants. Even if several studies have been done on industrial corporations and banks, the literature of insurer rating determinants is limited and it sometimes does not provide fitness measures. Also, this literature considers a certain period of time, but it often does not analyse the determinants evolution. Nevertheless, this analysis is necessary for reviewing and adjusting credit risk models to face the operational environment changes. This paper reports results of 257 European insurance companies across two periods: 1999-2000 and 2002-2003, where financial information is used to discover rating determinants. This process is performed as follows: a data mining feature selection is done; then, multivariate classification models are developed through statistical approaches and decision trees. Results for each model and period are compared for identifying common points, differences, and tendencies in rating determinants.

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Related Party Transactions and Pre-IPO Operating Outperformance - Chinese Evidence

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This study provides evidence that Chinese IPOs significantly outperform the market at the pre-IPO period, but do not report a significant underperformance relative to the market at the post-IPO period. We find that the operating performance of IPO firms is highly associated with related party transactions between controlling shareholders and listed firms. The pre-IPO outperformance appears, primarily because controlling shareholders structure a large percentage of transactions with their pre-IPO subsidiaries to benefit their subsidiaries, and they do not expropriate their pre-IPO subsidiaries, or expropriate very little. However, at the post-issue period, controlling shareholders significantly expropriate listed subsidiaries via related loans, in return for profits and/or resources transferred into the subsidiaries at the pre-IPO period. The post-IPO operating performance is negatively associated with the loans by listed firms to controlling shareholders, which proxy for expropriation of listed firms.

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Earnings Management in Failing Companies

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The purpose of this paper is to examine whether failing companies' pre-bankruptcy financial statements are more likely to exhibit signs of earnings manipulation than those of continuing companies. Our main hypothesis is that managers of companies in distress have incentives to adopt income-increasing accounting choices to present a better picture of their company's financial position. This earnings management activity is expected to be more prominent in the years closer to the failure date. In addition, while we acknowledge the fact that managers of continuing companies may also have incentives to manipulate the accounts of their companies, as suggested by positive accounting theory, we expect the earnings manipulation of failing firms to be of a significantly higher magnitude than the respective one of the continuing firms. The data used to test our hypotheses come from UK public companies. In specific, we use at least three years of data of a big sample of companies that failed between 1998 to 2004, and also data for a sample of matched continuing companies. Preliminary findings suggest that managers of companies approaching bankruptcy tend to engage in significantly greater income-increasing accrual magnitudes than do the managers of the control companies. Also, we find that distressed firms display significantly more negative changes in cash flows from operations and a greater disparity between accrual-based net income cash flows from operations than do continuing firms.

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The Impact of the Business Cycle on the Value-Relevance of Disaggregated Earnings Components

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In this paper, we investigate whether investors' valuations of the growth and non-growth characteristics of reported earnings are likely to be conditioned on the business cycle. To test this proposition, we decompose earnings into three components: core earnings (CORE), stable earnings growth (GROWTH), and a residual term that captures changes to earnings not unambiguously related to CORE earnings or stable GROWTH. We then examine the value relevance of the CORE and stable GROWTH components of earnings across different stages of the business cycle. We hypothesize that the value-relevance of core earnings should be relatively greater during periods of recession because (a) investors seek a safe haven for equity capital, (b) credit crunch conditions drive up the cost of external sources of capital, making internal capital sources, including CORE earnings, more valuable, and (c) greater CORE earnings during recession allows firms to more easily exploit bargain purchase opportunities that are more likely to arise during recession. Second, we expect GROWTH to be relatively more value-relevant during expansion than in recession because the likelihood of the firm sustaining stable growth is higher when the economy in general is expanding. Our empirical results support our priors.

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Value relevance of R&D capital information: evidence from Tokyo stock exchange

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The Japanese Business Accounting Council issued Accounting Standard for Research and Development costs in March 1998. This standard was applied in fiscal years beginning after April 1, 1999, where an entity expensed all R&D costs in the period when they are incurred unless they have alternative future uses, which is rarely the case. If whole R&D costs are expensed in the period they are incurred, the book value does not reflect probable future economic benefits as a result of R&D investments. One of the basic ideas is whether investors in Tokyo stock exchange regard R&D investments as capital which generates future benefits or not. The other one is whether R&D investments contribute to future financial performance. To address these concerns, we first investigate the value relevance of R&D costs to share prices by using corporate valuation model which is extended version of standard Ohlson model. Then we estimate the R&D capital and investigate whether these estimates are statistically reliable and economically meaningful. We address R&D costs contribute to operating income for four years on average for firms listed in Tokyo stock exchange, shorter than seven years in United States. We finally document a significant association between R&D capital and subsequent stock return, particularly positive excess returns for R&D intensive firms. We conclude that we could present sufficient evidence to the capitalization and amortization of R&D costs in Japan.

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The Value-Relevance of Earnings Management

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Since 1996 onwards, the fraudulent financial reporting by the gigantic companies in both the U.S. and the local stock markets has led to huge social loss, and worst of all, the lost of investors' confidence in the accounting numbers. This paper attempts to observe whether capital market responses to earnings management efficiently in the stock returns. The paper is based on the American stock market, and explores the relationship between stock returns and net income components under three earnings management hypotheses (i.e., performance measure hypothesis, opportunistic accrual management hypothesis, noise hypothesis) in both short and long intervals. The empirical results suggest that, the correlation between stock returns and net income is different under different earnings management hypotheses. The correlation between stock returns and discretionary accruals is different, too. Finally, the relationship between stock returns and discretionary accruals is less significant as the time intervals expand. The empirical result implies that, based on the data collected in this study, stock returns are able to reflect the impact of earnings management in the U.S. stock market, i.e., earnings management is value-relevant.

Keywords: value-relevance, earnings management, the performance measure hypothesis, the opportunistic management hypothesis, the noise hypothesis, discretionary accruals.

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Bank loan officer's informational needs and mandatory accounting information

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Banks are supposed to respond to imperfect information in credit markets. They are thought to access private information and to create additional information through credit granting.

This means two things. First, mandatory accounting information is not sufficient to create a state of perfect information. Second, because of their status of delegated monitors it could be interesting to identify the private information used by banks. In fact, this information could help to understand their superiority as monitors and their informational needs. This could be interesting for accounting standard-setting. Based on interviews with bank loan officers, this study tries to identify what questions they attempt to answer while analysing and monitoring a credit file, what information they need and what are the problems with accounting information. We find that the analysis of borrower's risk relies heavily on bank private information and on bank shared information through Banque de France. But, bank loan officers look for more information, like risk indicators. The main problem with mandatory accounting information is its timeliness that does not allow an effective monitoring. Moreover, hardly gives it information about real cash and cash flows. So, supplementary non-accounting indicators are needed. Finally, our verbatim underline the need for cross validation by different information, including accounting information. This cross validation answers to several needs, one being justification.

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Market Uncertainty and Disclosure of Internal Control Deficiencies under the Sarbanes-Oxley Act

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This study examines the cross-sectional difference of stock market reactions to disclosures of internal control deficiencies under Section 302 of the Sarbanes-Oxley Act. We also examine the determinants of firm disclosure decisions on internal control weaknesses. We hypothesize that if an internal control disclosure helps reduce the market uncertainty around the disclosure, the market punishment for internal control problems will be less severe. Consistent with our hypothesis, we find that when firms disclose their internal control deficiencies, their abnormal stock returns are negatively associated with changes in the standard deviations of daily stock returns around disclosures. We also provide evidence that such a negative relation appears only for "voluntary" disclosures of internal control deficiencies that are less severe than the level of material weakness. Further, we find that firms experiencing high stock return volatilities tend to disclose their internal control problems early.

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Determinants of the disclosure of prospective financial information by Spanish firms: an empirical study

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Financial accounting information has its limitations, one being its historical nature. However, for being able to make informed and rational economic decisions, users of accounting information will also require information about the future. Accounting literature is interested in investigating the reasons that lead companies to comply with users' information demands. Assuming a users' claim for the disclosure of prospective financial information, we study the factors that influence it. Our paper has a double objective: on one hand, we aim to determine the nature and level of publication of prospective financial information by Spanish firms; on the other hand, we analyze the factors that influence such disclosure. For that purpose, we study a sample of listed companies, in the period 2001-2003. We look at information disclosed in financial statements, but also in prospectuses and other communications to the Spanish securities and exchange commission (CNMV). Results show that the information disclosed is largely of qualitative nature, and that the level of prospective information included in the financial statements seems to be low, despite the legal requirements for the disclosure of this sort of information. Regarding the factors that determine the disclosure, we find a relationship between firms' characteristics (as size, leverage, growth in sales revenue and international listing) and an index that measures the level of information disclosed.

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Why Does Market Undervalue Research and Development Expenditures

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This paper examines whether and why Japanese stock market undervalues Japanese firm's research and development using financial data from 1986 to 2000. The empirical analysis shows that stock prices do not fully incorporate R&D investment, and that R&D intensity is positively related to future stock returns. To investigate why R&D investment is undervalued, this paper tests the functional fixation hypothesis and the information asymmetry hypothesis. In Japan, GAAP permitted, but did not require, the capitalization and subsequent amortization of R&D investments. However, in practice more than half of Japanese firm expensed its R&D investment immediately. The functional fixation hypothesis means that investors undervalue R&D investment, since investors may mechanically accept firm's financial statements at face value without adjusting for the long-term economic benefit of R&D. In addition, accounting information about a firm's R&D activity is generally of limited usefulness. The information asymmetry hypothesis means that the market is slow to recognize the benefit of R&D, since financial statements do not provide the useful information about R&D activities. This paper provides some evidence consistent with the information asymmetry hypothesis. Finally, this paper shows that R&D intensity is positively related to the volatility of returns. These findings suggest that the lack of accounting disclosures about R&D activities causes the mispricing and higher return volatility.

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Do Value Stocks Outperform Growth Stocks around the Release of Firm's Financial Results? Evidence from the Irish Stock Exchange

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In this paper we explore whether expectational errors play a significant role in explaining the superior returns to value stocks over growth stocks on the Irish Stock Exchange. To do this we examine the market's reaction to firms' preliminary and interim results to assess whether the market makes systematic errors in pricing. Specifically we test whether market surprises in the period around the release of firms' formal accounting releases in the two years after portfolio formation are systematically higher for value stocks than for growth stocks. We find that value stocks do indeed outperform growth stocks in the 3-day period surrounding the release of firms' financial results for the two-year period following portfolio formation. However, in contrast to extant US research, we are unable to reject the possibility that the returns differentials are driven by fundamental risk factors rather than by investors' tendencies to extrapolate past earnings growth too far into the future.

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Equity Subscriptions in Listed Property Trusts: Debt or Equity?

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This study investigates the market reaction of listed property trusts (LPT) to requirements that investor equity subscriptions in registered schemes be reclassified as debt. Assets of LPT are held by a corporate trustee for the benefit of investors with contractual obligations stipulated in the constitution of the trust (i.e. the trust deed). Under trust law, the trust deed contains a perpetuity clause which determines the life of the trust. At such time, the trustee is obliged to distribute the net assets of the trust to beneficial investors. Under accounting regulation on the presentation and disclosure of financial instruments, such contractual arrangements require the investors' equity subscriptions to be classified as financial liabilities. Concerned about the inappropriateness of this classification, industry groups have lobbied both the accounting standard setting body and the corporate regulator. To 'maintain market efficiency' and avoid LPT's equity being reclassified as debt, the corporate regulator issued a class order permitting the removal of the perpetuity clause from trust deed. By investigating market reactions to key events associated with the classification of LPT investor equity subscriptions, this study contributes to understanding the economic consequences of accounting regulation. It assesses whether regulated accounting classification of financial instruments is consistent with investors' and preparers' perceptions of the instruments' debt/equity economic attributes.

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Financial analysts and the exchange effect

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As a result of the documented differences in NASDAQ and NYSE firms' information environments in Grant (1980) and Atiase (1987), the literature is currently 'puzzled' about the exchange effect on investors' behaviour. In this study, I contribute to the literature by examining a specific snippet of a firm's information environment: namely information gathered and sorted out by sell-side financial analysts. I study U.S. firms that were originally listed on NASDAQ and subsequently changed to the NYSE. Using a [-3,+3] event window, I find that the expected improvement in a firm's information environment following a switch to the NYSE does not show up but only after three years. This result is found robust against several specification and robustness checks. Further analysis indicates that this temporal delay is possibly caused by another event coinciding with a firm's decision to change exchange market. Using I/B/E/S analyst codes, I find that about 60% of the analysts formerly involved with a NASDAQ firm are replaced by other analysts following a firm's switch from NASDAQ to the NYSE. This suggests that lack of firm-specific experience with novice analysts (see also Mikhail *et al.* (1997)) could give cause for the temporal decay of a firm's information environment as documented in this study. Taken together, the findings documented in this study leave no room for conclusive inferences. Hence, unfortunately, the 'puzzle' remains.

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**Directional Volume Reactions to
Earnings Announcement in Japan**

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This study examines the behaviour on buy- or sell-initiated trades around earnings news release. Based on quote tests, we classify trades at the ask (bid) price as buy- (sell-) initiated. We also regard earnings announcement as good (bad) if actual earnings per share are more (less) than the latest consensus analyst earnings forecast. Intuition suggests that buy-initiated trades after good news releases should significantly increase, while sell-initiated trades after bad news releases should significantly increase. However, our findings differ from this intuitive prediction. Buy-initiated trading reaction to earnings announcements is significantly positive regardless of whether news has been good or bad. Sell-initiated trading reaction is significantly positive as well. These results indicate that some investors buy or sell stocks at the time of earnings releases without regard for the kind of news received. Moreover, we examine whether buy- or sell-initiated trades are predominant after good and bad news releases, using order imbalance measure based on Lee (1992). We find that in the good news samples buy-initiated trading is outnumbered. However, in bad news samples buy-initiated trade is also dominant. Therefore we find that buying activities around earnings news releases are predominant in both good and bad news samples.

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Generation of private signals by analysts

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We investigate the relationship between public signals in capital markets and the generation of private signals by information intermediaries (analysts). The relation between earnings quality and forecast quality is modelled as an equilibrium response by analysts to public signal quality. The private signal is generated by a monopolist analyst, who is modelled as selecting both the quality of information he generates and the price for which that information signal is made available for sale to traders. Using simulation techniques, we find that the analyst's optimal signal generation response varies according to the quality of public information available. In particular, to minimise free-riding and so maximise his profit from sale of the signal, the analyst sometimes has an incentive to generate a signal of a quality below the maximum of which he is capable. Modelling the analyst in this way gives rise to implications in the market for private information; in particular, it implies a particular form of relationship between public signal quality and the quality of the private signal generated by the analyst: when public information quality is high, the analyst reduces his forecast quality as public information quality increases. Our findings are consistent with the predicted behaviour.

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**The Value Relevance of Earnings in the UK,
the USA and France**

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In this study we examine and test empirically six major hypotheses that relate to the role of financial information, namely earnings and cash flows, in three major capital markets, two Anglo-Saxon, the UK and the USA and one code law country, France. A theoretical framework is developed to set the groundwork for building up the research hypotheses. We hypothesize that the homogeneity across firms may not hold, due to firm-specific, industry-specific, and country specific differences across firms. The dataset consists of 36,695 USA, 4,234 UK and 1,181 French firm-year observations over a nine-year period. Multivariate statistical regression analysis is undertaken to test the major research hypotheses. The evidence provided in this study supports that indeed there are substantial differences in the way investors and financial analysts perceive financial information such as earnings and cash flows in the UK, France and the USA. Specifically, results indicate that indeed both earnings and cash flows are taken into consideration by investors in their investment decisions but they differ depending on the country of investigation. Second, evidence shows that investors pay more attention to longer-run earnings and cash flows rather than to shorter-run financial information. Third, when earnings are transitory (not stable), investors pay more attention to cash flows and less attention to earnings, a result indicating that investors penalize firms with unstable earnings. Fourth, results show that the value relevance of earnings and cash flows is country specific. Specifically, results indicate that earnings are valued more in France and less in the Anglo-Saxon countries, due to the fact that the financial reporting in the Anglo-Saxon countries is much more liberal (less conservative) and managers may manipulate easier financial information. Moreover, as hypothesized, results show that cash flows are the most (least) value relevant in the USA and the UK (France).