Yale School of Management
Doctoral Seminar: Empirical research in accounting
Spring 2015
Friday 1:15pm – 4:15pm Room 2230

Instructor: Alina Lerman alina.lerman@yale.edu
165 Whitney Avenue, #3526 203-432-6024

Course Materials:
I will make all the relevant papers available to you on Classes*v2.

Course Goal:
The objective of this course is to introduce you to several areas of empirical research within the financial accounting literature. Since the areas we will cover extend over a number of both related and unrelated fields only a superficial coverage of the topics will be possible. The goal is to introduce the types of questions asked in these areas, to think about how these questions may relate to each other and to questions in other disciplines, and to get you to think about issues you may want to research. Ultimately, the goal of this course is to help you in the process of becoming a researcher capable of identifying interesting, important, and researchable topics related to empirical financial accounting.

Course Organization:
Each class will follow roughly the same pattern. I will spend about 20-30 minutes of a class on a lecture regarding the relevant research area touching upon the background of the research, some related questions which we are not explicitly covering, general themes or issues in this research, and recent developments. The rest of the class will be spent on 3 papers representing different facets or questions within the research area explored. Generally, the discussed papers are all “classic” published papers. This should not suggest that they need be accepted without question – rather they were chosen because they give a good sense of the research on a given topic and have contributed greatly to a fertile research area. One student will present one paper in a 45 minute window. The presenters are expected to give a summary of the paper and to evaluate and/or pose questions regarding the critical aspects of the paper: topic choice, hypotheses, research design, sample, empirical methods, etc. You should focus on issues such as the importance of the topic, the testability of the hypotheses, the validity and power of the research design, the interpretability of the empirical results (and alternative explanations for the empirical results). What questions did the authors asked and successfully answered and what is left for future research?

All participants in the course are expected to read the 3 papers discussed at the session and should come prepared with questions and comments. In addition, the syllabus contains a list of related papers for each session. These were selected to represent background papers, follow up work, critiques of the discussed papers, papers addressing related questions and survey papers summarizing the literature on the topic. While you are not required to read all of these papers for the class session you may find having this list useful if you want to dig deeper within any given topic.

Course Grading:
The course grade is based equally on three items: a) the presentations you will make in class for the papers assigned to you, b) a referee report of an empirical working paper (assigned several weeks before the end of class), and c) thoughtful class participation for papers that you will not be presenting.
We are starting with January 23 since January 16 is both the make-up day for Monday MLKJ classes and the FARS mid-year conference.

1. **January 23: taught by Jake Thomas**

**TOPIC:** Valuation Formulae

**CLASS:** One of the major advances in recent research is the ability to convert earnings forecasts into “fundamental” valuations, and the exact formulae for P/B and P/E. We will develop the algebra behind the AE model, the P/B model, and the P/E model.

2. **January 30:**

**TOPIC:** Valuation Using Abnormal Earnings Models

**CLASS:** Building on the models discussed in prior class we will consider the proximity of US stock market prices to valuations generated by models based on residual income, accounting earnings, various components of earnings and multiples. The papers will frequently assume market efficiency and test against it. We will not spend significant time on issues such as earnings response coefficients and time series of earnings (those will be covered in detail in the second half of the two year Empirical Accounting sequence in Spring of 2012).

**PAPERS:**
- Abarbanell and Bernard “Is the US stock market myopic?”
- Lee, Myers and Swaminathan “What is the intrinsic value of the Dow?”
- Liu, Nissim and Thomas “Equity valuation using multiples”

**Related Papers:**
- Claus and Thomas “Equity premia as low as three percent? Evidence from analysts’ earnings forecasts for domestic and international stock market”
- Dechow, Hutton and Sloan “An empirical assessment of the residual income valuation model”
- Frankel and Lee “Accounting valuation, market expectation, and cross-sectional stock returns”
- Kothari “Capital markets research in accounting”
- Liu and Thomas “Stock returns and accounting earnings”
- Penman and Sougiannis “A Comparison of Dividend, Cash Flow, and Earnings Approaches to Equity Valuation”
- Thomas and Zhang “Don't fight the Fed model!”
Depending on the timing of the Accounting Recruiting Conference we may have to reschedule the February 6 class

3. **February 6:**

**TOPIC:** Cost of Equity Capital

**CLASS:** We will discuss various techniques for estimating the cost of equity capital and limitations of various methodologies. We will also note the firm characteristics and choices that may impact the cost of capital.

**PAPERS:**
- Gebhardt, Lee and Swaminathan “Toward an Implied Cost-of-Capital”
- Botosan and Plumlee “Assessing Alternatives Proxies for Expected Risk Premium”
- Gode and Mohanram “What Affects the Implied Cost of Equity Capital”

**Related Papers:**
- Botosan “Disclosure Level and the Cost of Equity Capital”
- Easton “PE Ratios, PEG Ratios, and Estimating the Implied Expected Rate of Return on Equity Capital”
- Francis, LaFond, Olsson and Schipper “Costs of Equity and Earnings Attributes”
- Lambert, Leuz and Verrecchia “Accounting information, disclosure, and the cost of capital”
- Larcker and Rusticus “On the use of instrumental variables in accounting research”
- Miller and Modigliani “Some Estimates of the Cost of Capital to the Electric Utility Industry”
TOPIC: Mispricing of Accounting Information

CLASS: The papers we will examine in detail explore the widely studied examples of market inefficiencies/anomalies: the post earnings announcement drift, the accrual anomaly and the glamour-value mispricing. In addition, in the class section we will touch upon the market efficiency assumptions, other observed anomalies, testing for several anomalies contemporaneously and some measurement issues.

PAPERS:
- Bernard and Thomas “Post-Earnings-Announcement Drift: Delayed Price Response or Risk Premium?”
- Sloan “Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings”
- Lakonishok, Shleifer and Vishny “Contrarian Investment, Extrapolation, and Risk”

Related Papers:
- Bernard and Thomas “Evidence that stock prices do not fully reflect the implications of current earnings for future earnings”
- Collins and Hribar “Earnings-Based and Accrual-Based Market Anomalies: One Effect or Two?”
- Daniel and Titman “Market Reactions to Tangible and Intangible Information”
- Hirshleifer, Hou, Teoh and Zhang “Do Investors Overvalue Firms with Bloated Balance Sheets”
- Jegadeesh and Livnat “Revenue Surprises and Stock Returns”
- Kraft, Leone and Wasley “An Analysis of the Theories and Explanations Offered for the Mispricing of Accruals and Accrual Components”
- Livnat and Mendenhall “Comparing the Post-Earnings Announcement Drift for Surprises Calculated from Analyst and Time Series Forecasts”
- Ng, Rusticus and Verdi “Implications of Transaction Costs for the Post–Earnings Announcement Drift”
- Thomas and Zhang “Inventory Changes and Future Returns”
5. **February 20:**

**TOPIC:** Market Microstructure and Other Settings

**CLASS:** We will expand the previous topic of securities market reaction to accounting information over a long window to include a look at some other settings: very short windows, windows preceding the accounting disclosure and options markets. We will also briefly discuss other information which may be gleaned from microstructure data such as liquidity, types of traders, etc.

**PAPERS:**
- Lee, Mucklow and Ready “Spreads, depths, and the impact of earnings information: An intraday analysis"
- Patell and Wolfson “The Ex Ante and Ex Post Price Effects of Quarterly Earnings Announcements Reflected in Option and Stock Prices”
- Ball and Shivakumar “How Much New Information is There in Earnings?”

**Related Papers:**
- Affleck-Graves, Callahan and Chipalkatti “Earnings Predictability, Information Asymmetry, and Market Liquidity”
- Amin and Lee “Option Trading, Price Discovery, and Earnings News Dissemination”
- Callahan, Lee and Yohn “Accounting information and bid-ask spreads”
- Glosten and Milgrom "Bid, Ask, and Transactions Prices in a Specialist Market with Heterogeneously Informed Traders" *(theoretical)*
- Krinsky and Lee “Earnings Announcements and the Components of the Bid-Ask Spread”
- Lee “Earnings news and small traders: An intraday analysis”
6. **February 27:**

**TOPIC:** Earnings Management – Measurement

**CLASS:** The literature on earnings quality and earnings management is one of the largest in accounting research. One set of studies examine the factors which impact earnings quality while another focuses on the consequences of differential earnings quality. It has been tied to cost of capital, capital market reactions, compensation and real economic decisions among others. The difficulty of earnings quality literature, however, lies both in conceptualizing and measuring earnings quality. For this reason we will include a discussion on literature that dubs itself as related to “earnings quality” but will focus the presentations on the common approaches to measuring managed and unmanaged earnings: separating discretionary and non-discretionary accruals, linking accruals to cash flows and examining earnings distributions around thresholds.

**PAPERS:**

- Jones “Earnings Management during Import Relief Investigations”
- Dechow and Dichev “The quality of accruals and earnings: The role of accrual estimation errors”
- DeGeorge, Patel and Zeckhauser “Earnings Management to Exceed Thresholds”

**Related Papers:**

- Biddle and Hilary “Accounting Quality and Firm-Level Capital Investment”
- Brown and Caylor “A temporal analysis of quarterly earnings thresholds: Propensities and valuation consequences”
- Dechow, Ge and Schrand “Understanding earnings quality: a review of the proxies, their determinants and their consequences”
- Dechow, Sloan and Sweeney “Detecting Earnings Management”
- Durtschi and Easton “Earnings management? The shapes of the frequency distributions of earnings metrics are not evidence Ipso Facto”
- Francis, Lafond, Olsson and Schipper “The Market Pricing of Accruals Quality”
- Healy “The effect of bonus schemes on accounting decisions”
- McNichols “Discussion of The Quality of Accruals and Earnings: The Role of Accrual Estimation Errors”
- Thomas and Zhang “Identifying unexpected accruals: a comparison of current approaches”

**SPRING BREAK** – no class on March 6, 13
March 20:

**TOPIC**: Earnings Management – Methods

**CLASS**: In the prior session we focused on *measurements* of earnings management and in this class we will explore the *methods* of earnings management and their implications. The presented papers will introduce the three most common types of earnings management: the accrual EM (or timing/reporting EM), the real EM and the expectations or guidance EM. Class discussion aided by the listed related papers will also touch upon motivations of EM (including signaling), detection and consequences. We will, for the most part, focus on GAAP-consistent EM, rather than on fraud which violates the accounting standards.

**PAPERS**:
- Defond and Park “Smoothing income in anticipation of future earnings”
- Roychowdhury “Earnings Management through Real Activities Manipulation”
- Bartov, Givoly and Hayn “The Rewards for Meeting or Beating Earnings Expectations”

**Related Papers**:
- Bens, Nagar and Skinner “Employee stock options, EPS dilution, and stock repurchases”
- Burgstahler and Dichev “Earnings management to avoid earnings decreases and losses”
- Cohen, Dey and Lys “Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes Oxley Periods”
- DeFond and Jiambalvo “Debt covenant violation and manipulation of accruals”
- Dhaliwal, Gleason and Mills “Last-Chance Earnings Management: Using the Tax Expense to Meet Analysts' Forecasts”
- Graham, Harvey and Rajgopal “The Economic Implications of Corporate Financial Reporting”
- Healy and Wahlen “A review of the earnings management literature and its implications for standard setting”
- Kedia and Phillipon “The Economics of Fraudulent Accounting”
- Kirschenheiter and Melumad “Can “Big Bath” and Earnings Smoothing Co-exist as Equilibrium Financial Reporting Strategies?” *(theoretical)*
- Tucker and Zarowin “Does Income Smoothing Improve Earnings Informativeness”
8. March 27:

**TOPIC:** Reporting Choices

**CLASS:** Another large stream of literature in the accounting research deals with mandatory and voluntary disclosures by firms. We will focus on three example of reporting issues in the presented papers: recognition vs. disclosure, use of Pro-Forma reporting, and choice of item classification in the context of segment reporting. In the background discussion we will also touch upon the interplay between mandatory and voluntary disclosure, the costs of disclosure, issues of endogeneity in reporting choices, sticky disclosure policies and choices related to language.

**PAPERS:**
- Ahmed, Kilic and Lobo “Does recognition versus disclosure matter? Evidence from value-relevance of banks’ recognized and disclosed derivative financial instruments”
- Doyle, Lundholm and Soliman “The Predictive Value of Expenses Excluded from ‘Pro Forma’ Earnings”
- Botosan and Stanford “Managers' Motives to Withhold Segment Disclosures and the Effect of SFAS No. 131 on Analysts' Information Environment”

**Related Papers:**
- Aboody, Kasznik and Williams “Purchase versus pooling in stock-for-stock acquisitions: Why do firms care?”
- Bhattacharya, Black, Christensen and Mergenthaler “Who Trades on Pro Forma Earnings Information?”
- Bushman, Piotroski and Smith “What determines corporate transparency”
- Einhorn “The nature of the interaction between mandatory and voluntary disclosures” (*theoretical*)
- Frankel, Johnson and Skinner “An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium”
- Kanodia “Accounting Disclosure and Real Effects”
- Li “Annual Report Readability, Current Earnings, and Earnings Persistence”
- McVay “Earnings Management Using Classification Shifting: An Examination of Core Earnings and Special Items”
- Verrecchia “Essays on Disclosure” (*theoretical review*)
- Verrecchia and Weber “Redacted disclosure”
9. April 3:

**TOPIC:** Asymmetries in Reporting

**CLASS:** There are several distinct thresholds which differentiate both the reporting behavior of firms and that of investors and other consumers of accounting information. The contrasts that we will explore in this class are profit vs. loss firms, good news vs. bad news, and good economic times vs. bad economic times. All of these will exhibit differences in terms of informativeness of accounting reporting. In the context of good and bad news we will touch upon both the ex-post reporting of earnings and the preliminary disclosures in the form of management forecasts and warnings.

**PAPERS:**
- Hayn “The information content of losses”
- Skinner “Why Firms Voluntarily Disclose Bad News”
- Conrad, Cornell and Landsman “When is Bad News Really Bad News?”

**Related Papers:**
- Aboody and Kasznik “CEO Stock Option Awards and Corporate Voluntary Disclosures”
- Barth, Elliott and Finn “Market rewards associated with patterns of increasing earnings”
- Darrough and Ye “Valuation of loss firms in a knowledge-based economy”
- Field, Lowry and Shu “Does Disclosure Deter or Trigger Litigation?”
- Kasznik and Lev “To Warn or Not to Warn: Management Disclosures in the Face of an Earnings Surprise”
- Kothari, Shu and Wysocki “Do Managers Withhold Bad News?”
- Miller “Earnings Performance and Discretionary Disclosure”
- Pinnuck and Lillis “Profits versus Losses: Does Reporting an Accounting Loss Act as a Heuristic Trigger to Exercise the Abandonment Option and Divest Employees?”
- Soffer, Thiagarajan and Walther “Earnings Preannouncement Strategies”
- Veronesi “Stock market overreaction to bad news in good times: A rational expectation equilibrium model” *(theoretical)*
April 10:

**TOPIC:** Regulation and Changes in Regulation

**CLASS:** We will start the class with a brief discussion on the goal of accounting standards and the FASB conceptual framework. The presented papers will focus on market-wide changes in accounting and financial regime: SOX, Regulation FD and IFRS adoption. We will focus both on the specifics of the guidance and the impact of the new rules but also on the methodological difficulties of studies addressing regime changes. In addition we will refer to several other regulation topics.

**PAPERS:**
- Zhang “Economic Consequences of the Sarbanes-Oxley Act of 2002”
- Bailey, Li, Mao and Zhong “Regulation Fair Disclosure and Earnings Information: Market, Analyst, and Corporate Responses”
- Daske, Hail, Leuz and Verdi “Mandatory IFRS Reporting around the World: Early Evidence on the Economic Consequences”

**Related Papers:**
- Armstrong, Barth, Jagolinzer and Riedl “Market Reaction to the Adoption of IFRS in Europe”
- Barth, Landsman and Lang “International Accounting Standards and Accounting Quality”
- Blouin, Gleason, Mills and Sikes “Pre-empting disclosure? Firms' decisions prior to FIN 48”
- Bushee, Matsumoto and Miller “Managerial and Investor Responses to Disclosure Regulation: The Case of Reg FD and Conference Calls”
- Engel, Hayes and Wang “The Sarbanes–Oxley Act and firms’ going-private decisions”
- Linck, Netter and Yang “The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors”
- Watts and Zimmerman “Positive Accounting Theory: A Ten Year Perspective”
No Class on April 17

11. April 24:

**TOPIC:** Financial Analysts

**CLASS:** Financial analysts are an integral part of the accounting information framework as both consumers and producers of information in the capital markets. The literature on analysts spans both the finance and accounting research and we will only skim the surface of that most related to accounting. We will be focusing exclusively on sell-side analysts and almost exclusively on their forecasts rather than recommendations. We will discuss the choice and impact of analyst coverage, analyst bias and independence and characteristics of analyst forecasts such as dispersion and accuracy.

**PAPERS:**
- McNichols and O'Brien “Self-selection and analyst coverage”
- Lin and McNichols “Underwriting relationships, analysts' earnings forecasts and investment recommendations”
- Diether, Malloy and Scherbina “Differences of opinion and the cross-section of stock returns”

**Related Papers:**
- Abarbanell and Lehavy “Biased forecasts or biased earnings? The role of reported earnings in explaining apparent bias and over/underreaction in analysts’ earnings forecasts”
- Bagnoli, Beneish and Watts “Whisper forecasts of quarterly earnings per share”
- Barth, Kasznik and McNichols “Analyst Coverage and Intangible Assets”
- Bradshaw “How Do Analysts Use their Earnings Forecasts in Generating Stock Recommendations?”
- Clement “Analyst Forecast Accuracy: Do Ability, Resources and Portfolio Complexity Matter?”
- Gu and Xue “The Superiority and Disciplining Role of Independent Analysts”
- Hong and Kubik “Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts”
- Lim “Rationality and Analyst Forecast Bias”
- Ramnath, Rock and Shane “The financial analyst forecasting literature: A taxonomy with suggestions for further research”
12. May 1:

**TOPIC:** Auditors

**CLASS:** While the auditing research is extensive and rich it is frequently viewed as separate from the accounting capital markets literature. However, the auditor is meant to be the gatekeeper for the information released from the firm to various financial information users and as such their behavior should be of interest to financial empiricists. The presented papers will focus on audit effectiveness, auditor bias and independence and audit opinions while the class discussion will also refer to audit quality, change of auditor and the “too big to fail” arguments.

**PAPERS:**
- Nelson, Elliott and Tarpley “Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions”
- Frankel, Johnson and Nelson “The Relation between Auditors' Fees for Nonaudit Services and Earnings Management”
- Butler, Leone and Willenborg “An Empirical Analysis of Auditor Reporting and Its Association with Abnormal Accruals”

**Related Papers:**
- Becker, Defond, Jiambalvo and Subramanyam “The Effect of Audit Quality on Earnings Management”
- Blouin, Grein and Rountree “An Analysis of Forced Auditor Change: The Case of Former Arthur Andersen Clients”
- Bradshaw, Richardson and Sloan “Do analysts and auditors use information in accruals”
- Chung and Kallapur “Client Importance, Nonaudit Services, and Abnormal Accruals”
- Coffee “Understanding Enron: It's about the gatekeepers, stupid”
- Cunningham “Too big to fail: Moral hazard in auditing and the need to restructure the industry before it unravels”
- Francis and Krishnan “Accounting Accruals and Auditor Reporting Conservatism”
- Kinney, Palmrose and Scholz “Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right?”
- Raghunandan and Subramanyam “Market Information and Predictive Accuracy of the Going Concern Opinion”
May 8:

**TOPIC:** Other Users of Accounting Information

**CLASS:** While the rest of the semester focused on investors as consumers of financial information we will spend the last class focusing on other settings where accounting numbers are used. We will explore the use of accounting information in debt contracting, and specifically in loan covenants, in corporate governance contracting and as used by other parties: labor unions, credit rating agencies, the press, suppliers.

**PAPERS:**
- Beatty, Ramesh and Weber “The importance of accounting changes in debt contracts: the cost of flexibility in covenant calculations”
- Armstrong, Guay and Weber “The role of information and financial reporting in corporate governance contracting”
- Kraft “Rating Agency Adjustments to GAAP Financial Statements and Their Effect on Ratings and Bond Yields”

**Related Papers:**
- Bharath, Sunder and Sunder “Accounting Quality and Debt Contracting”
- Bova “Labor Unions, Employee Ownership, and Management's Incentive to Signal Declining Profitability”
- Dichev and Skinner “Large–Sample Evidence on the Debt Covenant Hypothesis”
- Dou, Hope and Thomas “Relationship-Specificity, Contract Enforceability, and Income Smoothing: An International Study”
- Healy and Palepu “Effectiveness of accounting-based dividend covenants”
- Jorion, Shi and Zhang “Tightening credit standards: the role of accounting quality”
- Miller, G., “The Press as a Watchdog for Accounting Fraud”
- Wittenberg-Moerman “The role of information asymmetry and financial reporting quality in debt contracting: Evidence from the secondary loan market”