The Accounting Podcast Series

S01E03: Mary Barth

Transcript

Albie: Welcome to TAPS, The Accounting Podcast Series. I'm Albie Brooks, and working with me on is Abbey Treloar.

Our guest today is Professor Mary Barth. Mary is Professor Emerita at the Graduate School of Business at Stanford University, having started there in 1995. Previously, Mary was at Harvard University. Mary is currently visiting here at Melbourne for a couple of weeks teaching into the PhD program and running some seminars. Broadly speaking, Mary's research focuses on financial accounting and reporting issues, with a particular emphasis on topics of interest to accounting standard setters. Mary has one of the most distinguished academic careers imaginable. Very briefly, Mary's academic publications stretch across all the major accounting journals. She was an inaugural member of the International Accounting Standards Board, President of the America Accounting Association 2013-2014, the recipient of numerous awards including: The Accounting Hall of Fame, American Accounting Association, 2018; Outstanding Accounting Educator Award, American Accounting Association, 2017, and; Notable Contributions to Accounting Literature Award, American Accounting Association and the American Institute of CPAs in 2012. Today we're going to hear from Mary about some of the key developments in financial accounting and standard setting, take a look at a couple of recent pieces of work Mary has been involved with, and finally look into the crystal ball and see what's ahead for financial accounting.

Welcome to TAPS, Mary.

Mary: Thank you, Albie.

A: Well, the question is where to begin? But let's get started. When you reflect on such a distinguished career in terms of research publications, which ones stand out most for you? Perhaps you'd like to comment on a couple of these.

M: Well, you start with a pretty difficult question, because research papers are like each one of your children. You're asking me to pick my favourite. But, as you mention, my particular interest is in research addressing standard setting issues. So those are the ones that stand out most to me. Let me comment on two of them that have been recognised with research awards which suggests they probably stand out for other people, too. The first is a paper that you mentioned, *International Accounting Standards and Accounting Quality*, with Wayne Landsman and Mark Lang, in *Journal of Accounting Research* 2008. The question we address in that paper is whether the change to international accounting standards (or IFRS, as it later became) from domestic standards increased financial reporting quality. Widespread application of IFRS is one of the biggest changes in financial reporting history. The question is whether this change enhanced the quality of financial reporting. Our sample in that study comprises firms from 21 countries from 1994 to 2003, so that means that those firms that are applying IFRS did so voluntarily. Using metrics from prior research, we find that after adoption of IFRS, firms have less earnings management, more timely loss recognition and more value relevance of accounting amounts. All of these indicate higher quality. These differences were not apparent before the firms adopted IFRS, but the firms that adopt IFRS experience an increase in these metrics. As you mentioned, this is the paper that received the Notable Contributions to Accounting Literature award in 2012. The other paper that stands out for me is *Fair Value Accounting for Liabilities and Own Credit Risk* with Leslie Hodder and Steve Stubben. It's in *The Accounting Review* in 2008. The question we address in that study is whether decreases in liabilities fair value arising from increases in credit risk represent income to equity holders, and vice versa. Recognising income when a firm is suffering economic difficulties seems to be counter-intuitive to some, but it is predicted from finance theory. We find that equity returns associated with credit risk changes are attenuated by the debt value effect of the credit risk change, as finance theory predicts. That is, after controlling for asset value changes, credit risk increases are associated with equity value increases, and vice versa. This arises because debt holders share in the firm's fortunes or misfortunes along with the equity holders. Without recognising the potentially offsetting effect of credit risk changes on debt values, the income effect, which inures to the equity holders, is overstated. We also provide some descriptive evidence that if unrecognised debt value changes were recognised in income but not on recognised asset value changes, most of the credit downgrade firms would recognise higher income, and vice versa. Fair enough. But these potentially counter-intuitive income effects primarily are attributable to incomplete recognition of asset value changes, not because of the debt value change. This paper received the AAA Deloitte Wildman Medal Award in 2009 for the paper published in the last five years that's most likely to affect the practice of accounting. Whether it did or not, we don't really know.

A: But that's a really nice thing to achieve, isn't it, because in the end we want to be able to impact practice.

M: Yeah, I think that's right. I think that's what we're trying to do is help everybody learn more about accounting and its effects on capital markets.

A: Okay, excellent. I realise the difficulty in asking you to pick out just a couple of papers to reflect on, but I really appreciate you picking out those in particular. We spoke with Naomi Soderstrom recently regarding accounting, the environment, and sustainability issues. You co-authored a recent study investigating integrated reporting quality and firm value. It seemed to me, from my reading of this, that there seemed to be some encouraging results for the proponents of integrated reporting. Perhaps you can share with us how the study was conducted, and perhaps a bit about the findings.

M: Sure. I think the paper you're talking about is *Economic Consequences Associated with Integrated Report Quality: Capital Market and Real Effects,* which is joint work with Steven Cahan and Li Chen at the University of Auckland and Elmar Venter at the University of Pretoria, published in AOS, *Accounting, Organizations and Society*, in 2017. So how we conducted the study, we – this has been a challenge for people trying to understand integrated reporting, but we take advantage of two facts. One is integrated reporting based on the International Integrated Financial Reporting Council's Framework is mandatory for South African firms that list on the Johannesburg Stock Exchange with a primary listing. And the second thing is that EY has commissioned professors from the University of Cape Town to evaluate the quality of these reports against the Framework criteria for several years in conjunction with EY's annual Excellence in Integrated Reporting Award. So EY graciously shared the report quality evaluation data with us, which gave us an independent and in-depth quality metric to use in our study instead of having to figure out the quality of these reports on our own. As for the findings, the International Integrated Financial Reporting Council's Framework identifies two goals for integrated reporting. The first is improved information for outside providers of financial capital, and the second is better internal decision making. So we extend prior research that also finds a positive association between integrated report quality and firm value by examining two channels through which this could arise. One is a capital market channel and the other is a real effects channel. To conduct these tests, we disaggregate firm value into three components: liquidity, cost of capital and expected future cash flows. We find a positive association between integrated report quality and liquidity, which supports the capital markets channel. We find no evidence of a relation between integrated report quality and cost of capital. We also find a positive association between integrated report quality and expected future cash flows. Because this association could reflect better investor cash flow forecasts – so it's higher cash flow forecasts, which is a capital market effect – or better internal decisions, that is a real effect relating to higher real cash flows, we try to distinguish these explanations. We find that higher integrated report quality is associated with higher realised operating cash flows, but not associated with greater analyst target price forecast accuracy. We also find higher integrated report quality is associated with higher investment efficiency. These findings support the real effects channel. So, taken together, we interpret our findings as being consistent with the goal of integrated reporting achieving a dual objective of improved external information for outside providers of capital, and better internal decision making that ends up being reflected in higher future cash flows and greater investment efficiency. So I guess in that respect, if you're a proponent of integrated reporting, I think you'd interpret our study in a positive light.

A: I think it's a good thing for organisations looking at pursuing integrated reporting or enhancing the quality of their integrated reports. South Africa have, of course, been doing this now for some time. Do you think we're going to see more adoption of integrated reporting?

M: I don't know. I actually think it's a promising area which – when you talk about the crystal ball for the future, it's a promising area. It may not be the answer, and exactly how to go about it I don't know. I know that in the United States people worry about volunteering too much for fear of legal ramifications or whatever. So until it's mandated, I'm not sure we'll see much take-up in the United States. Other countries I'm not really sure. I think that it's more prevalent in Europe than it is in some other places. But how the future unfolds is hard to tell.

A: Difficult to know. But I think some organisations, at least, are trying to do more in the space. Whether that's in their reporting or, ideally, it's also in their activities associated with their reporting. Thank you for that. So I think, yeah, we might come back to that during the crystal ball phase. In 2015 you wrote a commentary on the state – relating to adoption and use – of IFRS, which you've referred to in these couple of earlier papers, the international financial report standards. You came up with some conclusions at that time. So I'm wondering what those conclusions were, if you'd like to share those with us, and then has anything altered in the years since you wrote the commentary?

M: Well, in this commentary, *Prospects for Global Financial Reporting* that was in *Accounting Perspectives*, I think I observed that even though by 2015 many countries had required or permitted the use of IFRS by firms listed in the capital markets, the global shift to IFRS and really high quality financial reporting was incomplete, both in terms of the required or permitted use of IFRS – it wasn't universal – and in terms of the varied application and enforcement of the standards around the world. And, of course, you look at the International Accounting Standards Board agenda and they always seem to have more things on their agenda. So they have a list of things they want to improve to make the financial reporting even higher quality than it is. So at that time, the conclusion was the goal of truly global high quality financial reporting had not yet been achieved. I think that ultimate conclusion is exactly where we are today, it hasn't quite yet been achieved. But since I wrote that, I think there has been progress on a couple of dimensions. One, I think there's been progress on improving the standards. We have new standards on revenue, leases, financial instruments, insurance. These are some big topics that pervade lots of firms and I presume – I hope – the plan is that they're going to improve financial reporting. We'll see how things go. They should, but we'll see. And I also think progress has been made on the more consistent application and enforcement of the standards as firms and regulators across the world gain more experience in using IFRS and then sharing those experiences with each other. Of course, there's still more that can be done on both those dimensions, but I think we've made progress. The one place that progress seems to have stalled is on the more countries adopting IFRS dimension, in particular the United States, which is close to my – well, it is my home. It's not close to home; it is my home. Although I believe the United States supports the notion of high quality, consistent global financial reporting, it's unclear how exactly they want to achieve that goal. There had been an active convergence project between the Financial Accounting Standards Board in the US and the International Accounting Standards Board, not only convergence but also jointly dealing with financial standard setting issues and issuing joint standards. The revenue standard is a joint standard. The leasing standard is close, but not quite. Insurance standard, I don't think the US has even – I don't know where they are on that. But currently there are no active joint projects between the FASB and the IASB. And frankly, there isn't any momentum for the US to adopt IFRS. But this is a decision that is made above my pay grade, as they say, and so time will tell how this plays out.

A: And perhaps linked to that, looking ahead for financial accounting and standard setting – you've made some references to that in some responses already – what do you see as the big challenges?

M: I think one of the big challenges, and perhaps the biggest challenge, is figuring out what information outside providers of capital need to make their economic decision in today's world of a service- and technology-based economy with an abundance – an over-abundance of information that is available outside of financial reports. It used to be financial reports were the main source of information about firms and manufacturing was the bulk of the economy, and we learned how to account for those things very well. But we live in a different world now, and the question is how financial reporting or reporting is – the accountants are going to help do something with all of this information, make sense out of it, summarise it, aggregate it. That's what we do. But the information that investors need in these types of companies, because the economy is evolving and the information environment is evolving, and I think the biggest challenge for the accountant is to keep up with that. And that's where I was thinking about integrated reporting. It's one step beyond financial reporting to encompass many other things, the integrated bit of it. So I think that's a promising step, and that's kind of one step in this direction that I'm thinking about.

A: And linked to this, of course, is the educational aspect of the work that we do. In this changing world that you've referred to, what do you think are the key attributes of an accounting graduate in order to meet the needs of both organisations and this environment that we all find ourselves in?

M: Well, I think this isn't new but there may be more focus on it now. Today's accounting graduates have to really understand the why of accounting, and not just the how. So I think this means that they need to be educated in fields that are related with ours, and that is things like business, how businesses are run, what they're trying to achieve, economics, finance, and data analytics, frankly, because how are we going to gather up all this information? Not just learning the nuances of the accounting rules. And I think there is a lot of that in the undergraduate curriculum, but I think, at least in the US and some other places, there is, in my view, a little bit too much emphasis on memorising the rules, because unfortunately those change all the time. So if they have a bigger picture they would be able to understand those changes but also think ahead as to how the environment is changing and how accounting could evolve to help provide the needs to users of that information.

A: And perhaps finally, given your incredibly distinguished academic career, what advice would you be offering a young accounting academic wet behind the ears just starting off in their career?

M: Well, I'll tell you, this is a very exciting time to be entering accounting academia, as far as I can tell. There are so many questions that need to be addressed, and the world – the real world, as we like to call it from academia – needs academic help more than ever, I think, even as fundamentally as the very nature of financial reports and other reports to address these challenges that I've talked about. Accountants are the providers of information that supports informed decision making in many, many respects, whether it's outside the firm or inside the firm. It doesn't matter; that's our job. Determining what information is important for that and how best to convey that information have never been more important. I'm sorry, someday I'm going to have to retire and miss this, but it's a very exciting time for new people. There's just no end to the questions they can deal with.

A: This is a good thing, right, because sometimes you can hear people talk about young people or new people to the industry and entering academia, and some would say, "I'm not sure I'd advise that," but based on what you're saying it's a great time to be an academic, with so many challenges that exist and so many ways in which we can contribute.

M: Yeah, I think sometimes you can think of these challenges as, "Nobody cares about accounting anymore, it's not important in this world," but I would flip it around and say we have to step up to the plate and figure out how to make it important, because the world needs us.

A: Excellent. Well, maybe on that positive note it's a great time to draw this to a conclusion. It's been an absolute pleasure, Mary, and we really thank you for joining us here at TAPS, and we wish you well.

M: Thank you very much, and a pleasure to be here.

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