

Center for Accounting Research

Newsletter December 2010



**UNI
GRAZ**

Debt Contracts and Optimal Precision of Accounting Information



A new paper by CAR's Alfred Wagenhofer, jointly written with Robert Göx from the University of Fribourg, has been published in the latest issue of the European Accounting Review. The paper inquires into the optimal precision of accounting information in debt contracts. The analysis is based on a partial equilibrium model with rational expectations; it describes the problem of a financially constrained firm providing to lenders information on the value of the assets used as collateral in a financing contract for a risky investment project. The key result is that, in order to maximize the probability of undertaking the project, the optimal accounting system reports biased information in that low asset values are more precise measures of actual value than are high asset values; this system is consistent with conditional conservatism. In addition, the model compares an accounting system based on fair value and one based on historical cost. Accounting risk (measured by the volatility of the difference between reported values and actual values) is strictly greater under fair value than under historical cost measurement. The paper states that fair value is preferred by financially constrained firms, whereas historical cost is preferred by unconstrained firms.

To know more:

Göx, R., and A. Wagenhofer (2010). Optimal Precision of Accounting Information in Debt Financing. *European Accounting Review*, Volume 19, Issue 3, pp. 579-602.

New Researcher Joins CAR

A new researcher, Christian Groß, has joined CAR starting from November. His position is sponsored



by the Austrian Financial Reporting and Auditing Committee (AFRAC) and by PricewaterhouseCoopers (PwC). AFRAC is the Austrian standard setter for financial accounting and was founded to develop accounting standards, to participate in the international ac-

counting debate, and to advise the government on legislation in this field. PwC is one of the world's largest providers of assurance, tax, and business consulting services. Groß will work for CAR, particularly supporting AFRAC deliberations in international accounting, and he will pursue his PhD studies in Accounting. He is a recent graduate (Master in Financial and Industrial Management and Master in Environmental System Sciences with the special field of Business Administration) of Karl-Franzens-University. His research interests are mainly centered upon accounting, control and finance. CAR thanks the sponsors AFRAC and PwC for supporting this activity.



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Progress of IAAER-Granted Project on Earnings Quality

As reported in the December 2009 issue of the CAR newsletter, CAR has been awarded an international competitive grant by the International Association for Accounting Education & Research (IAAER) joint with KPMG International to carry out research on Earnings Quality as part of the "Informing the IASB Standard Setting Process Research Program". In connection with the IAAER World Congress in Singapore (November 4-6, 2010), CAR's Ralf Ewert and Alfred Wagenhofer presented their recent paper "Earnings Quality Metrics and What They Measure" in a by-invitation-only workshop where the five projects were discussed. The paper sets out an analytical model based on a capital market with asymmetric information and rational expectations to study issues of earnings quality and the behavior of various metrics that the empirical literature regularly employs to analyze the quality of accounting systems. The paper provides conceptual guidance for using these metrics in empirical studies and contains several testable hypotheses regarding earnings quality. The paper currently appears on three top ten download-lists of SSRN.



To know more:

Ewert, R., and A. Wagenhofer (2010). Earnings Quality Metrics and What They Measure. Available at: <http://ssrn.com/abstract=1697042>.

Market Makers as Information Disclosure Channel



The amount and the precision of the information disclosed to market participants before trading is a timely issue in the theoretical and empirical research on market design. In a paper published in the latest issue of the Journal of Empirical Finance, CAR's

Pietro Perotti and Barbara Rindi from Bocconi University investigate an alternative channel of information disclosure to firms and analysts. The paper focuses on the unique trading environment of STAR, a group of small medium-capitalization stocks listed in the Italian Stock Exchange. STAR stocks are assigned designated market makers (DMMs), which have both liquidity and information disclosure requirements. These information requirements require DMMs to provide financial analyses and to interact with investors on a regular basis. Because liquidity requirements are not binding, the analysis can concentrate on the effect of information disclosure requirements. The main result is that the bid-ask spread and price volatility decrease substantially, relatively to a matched sample of control stocks, after the assignment of the DMMs. These results can be explained by the concurrent decrease in information asymmetries, which are measured by the adverse selection component of the bid-ask spread and by the short and long term price impact of orders on prices.

To know more:

Perotti, P., and B. Rindi (2010). Market Makers as Information Providers: The Natural Experiment of STAR. *Journal of Empirical Finance*, Volume 17, Issue 5, pp. 895-917.

JAE Best Paper Prize Assigned to Prof. Wagenhofer

CAR's Alfred Wagenhofer, together with Robert Göx, received the Best Paper Prize for their paper "Optimal Impairment Rules" published in 2009 in the *Journal of Accounting Economics* (JAE). The prize was awarded during the annual JAE Conference

at Northwestern University this October. With a five-year impact factor of 3.931 JAE is the most

influential journal in accounting research internationally. At the JAE Conference, Alfred Wagenhofer was also invited to discuss the paper "From Low-Quality Accounting to Financial Crises: Politics of Disclosure Regulation along the Economic Cycle" by Jeremy Bertomeu and Robert P. Magee (both from Northwestern University).

To know more:

Göx, R., and A. Wagenhofer (2009). Optimal Impairment Rules. *Journal of Accounting and Economics*, Volume 48, Issue 1, pp. 2-16.

Empirical Accounting Research in Berlin

From September 14 to 17 a doctoral course on empirical accounting research, organized by the

German Academic Association for Business Research, was taught by Professor Joachim Gassen in Berlin. Four PhD students

of the University of Graz (Thomas Gaber, Magdalena Haring, CAR's Rebekka Kager, and Michael Vorraber) participated in the

course, which dealt with archival accounting research, covering theoretical, methodological and technical aspects. The topics involved disclosure and earnings quality issues. In the first part of the course reviewed papers were presented and discussed by the participants to expand the theoretical foundations as well as methodological knowledge. In the second part of the course students were assigned to small groups; each group was given a topic in the area of empirical accounting research. By setting up a model and conducting regression analyses the research questions were assessed. The results analyses had to be presented and defended by the group. The benefit of the course was not only the theoretical and methodological input but especially the team work with PhD-students from other universities.



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