# Opportunities and Challenges for Evidence-Informed Standard Setting and Regulation


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# Big Picture

- Policymakers, regulators & standard setters are increasingly under pressure to perform cost-benefit or economic analysis
  - DC Circuit's Business Roundtable v. SEC Decision
  - FASB, IASB, PCAOB are thinking about evidence-based rulemaking and ex post analysis
- Disclosure/reporting regulation is important research area
  - Regulation & standardization are core issues for financial accounting
  - Easy to see potential policy relevance & real-world impact of literature
- What can we actually say that is helpful to regulators?
  - What can we say about Reg FD, SOX and IFRS?
- Causal inferences play a critical role for cost-benefit analysis
  - Magnitudes really only matter once we have causal estimates
- But gold standard of randomized trial is often not feasible
  - We are still far from quantitative cost-benefit analysis

# What can we say?

- Large number of regulatory studies on many different outcomes
  - Solid evidence on some economic links (e.g., disclosure and liquidity) in part from regulatory studies (essentially exploiting mandates)
- But causal evidence often difficult to obtain & still relatively rare
  - Key limitation is how underlying observational data is generated
  - Institutional settings and the process by which new regulation arises
- There are cases where we get can get causal estimates
  - Thresholds and RDD
  - Staggered implementation of securities regulation
- But these settings are rare and effects may be quite local
- Piling up of studies does not really help the problem
  - Settings often suffer from same problem (no “diversification”)
  - Think about question of whether drinking wine is good for your health

# What can we say? (continued)

- Externalities, spillovers and other market-wide effects are at the core of the economic rationale for regulation
  - Surprisingly little evidence on these effects
  - Little evidence on when and by how the social value of disclosure differs from private value
  - We can say very little about welfare effects
  - Comparability effects are by design external effects
- Major research design challenges in showing these indirect effects
- These issues are discussed in more detail in forthcoming JAR survey by Leuz and Wysocki
  - Stayed tuned for revised version

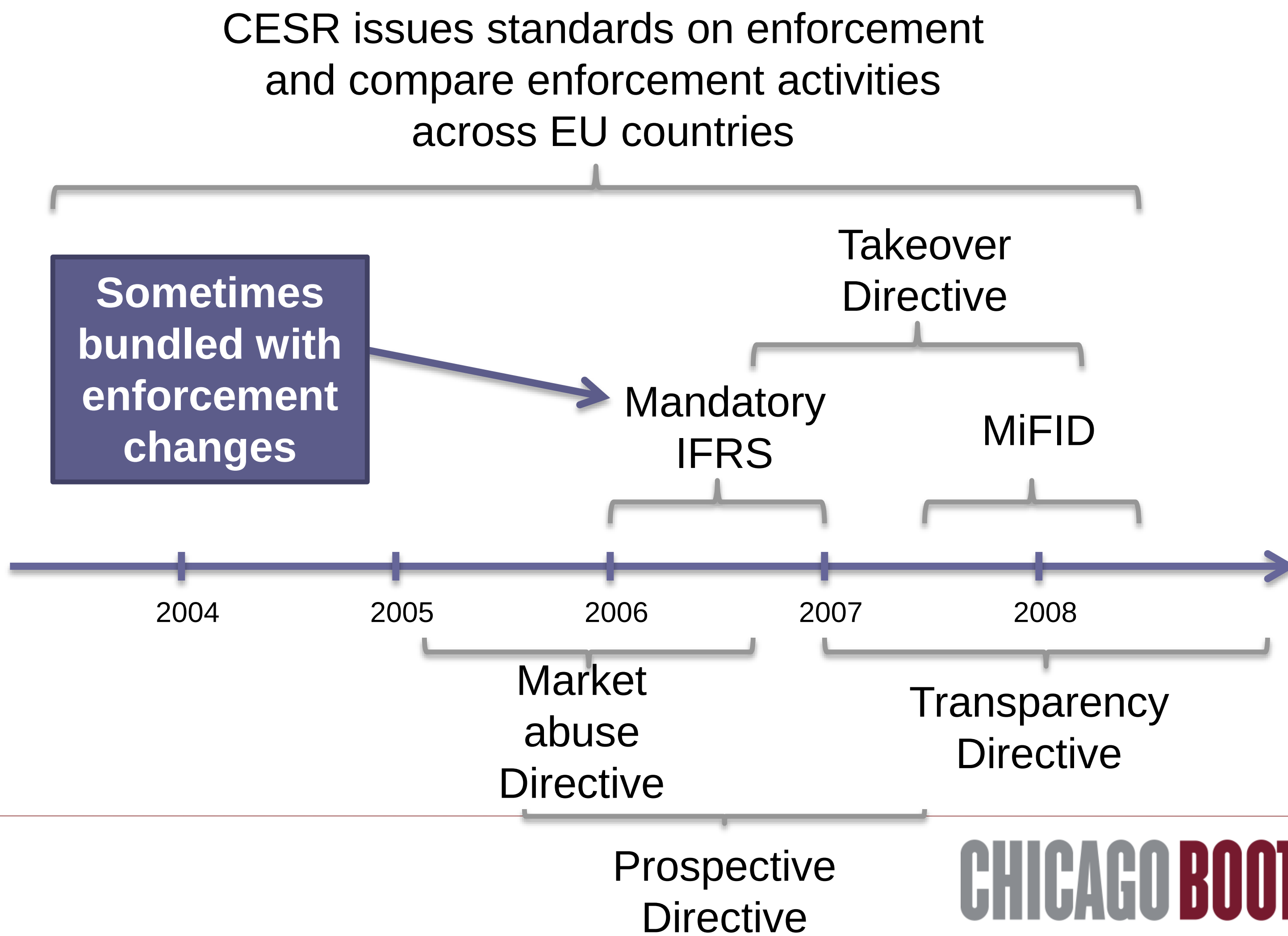
# Identifying Accounting Standard Effects

- International accounting literature analyzes the effects of IFRS adoption
  - IFRS could have a number of potential effects
  - High-quality and more comparable reporting likely has significant capital-market effects
- Key question is whether IFRS delivers or has these effects
  - Does corporate reporting improve or become more comparable with the introduction of IFRS?
  - What is the contribution of reporting standards?
- This question is obviously very important
  - For regulators but also for accounting researchers

# Our assessment of IFRS literature

- Huge international literature on reporting standards
  - Much of the literature focuses on mandatory IFRS adoption
- But studies are generally not able to attribute observed effects directly to IFRS adoption per se
  - Illustrates that "piling up" of research does not really work
  - Studies must be more careful about how results are attributed
- Face major identification challenges
  - Concurrent but unrelated events (e.g., MAD in the EU)
  - Concurrent changes to the reporting system (e.g., enforcement) – endogenously tied to IFRS adoption
  - Issue is particularly pronounced in studies with slow-moving or low-frequency outcome variables (e.g., earnings quality)

# Timeline of Selected Regulatory Changes in Europe around IFRS Adoption



# Christensen, Hail and Leuz (JAE 2013)

- Why did we do this study?
  - Research shows substantial capital market effects around IFRS
  - Reasons to believe that the sources of these effects are unclear
  - Concern about misinterpretation
- Example - EU Commission's evaluation of IFRS mandate:

  "… [IFRS] studies indicate that there is an overall reduction in the cost of capital for companies supplying IFRS…"
- Policy relevance means that it is important to establish whether documented benefits are attributable to switch in accounting standards
- Daske, Hail, Leuz and Verdi (2008) already raised significant concerns:
  - Substantial heterogeneity in the capital-market effects
  - Points to effects for the voluntary adopters <u>in the year</u> when mandatory IFRS reporting is introduced
  - The paper states explicitly that are likely not solely or primarily due to IFRS

# What can we say based on the evidence?

- The results in CHL are difficult to reconcile with the notion that the IFRS mandate led to major capital-market effects.
  - We find no effect around IFRS alone, including when institutions are strong.
  - We find effects when IFRS and enforcement changes are bundled together and around enforcement changes alone (with and w/o IFRS).
- Our results suggest that changes in enforcement are crucial for the observed liquidity effects around mandatory IFRS.
  - The results do not simply say: "Enforcement matters"
  - In fact, the paper does not show a causal effect of enforcement (not its goal!)
  - It is unlikely that IFRS played a major role in the liquidity effects
- We cannot rule out that IFRS play some role
  - But: We find effects for early voluntary adopters around the mandate ($\Delta$ENF) and these effects are similar to effects for mandatory adopters ($\Delta$IFRS + $\Delta$ENF)
  - These findings are inconsistent with a joint effect or complementarity

# Important caveats

- We also cannot say that other countries would experience similar effects if they changed enforcement
  - Again, the paper is not about enforcement but about the role of IFRS
- Results are limited to market liquidity
  - Future studies may be able to document effects around IFRS outside the 5 EU countries using other variables
- But it is important that it is not enough to look at our splits by concurrent enforcement
  - There are also concerns about unrelated changes to regulation that could affect the outcome variables (e.g., MAD, TPD, PD, etc.)
  - That is, studies need designs to separate these effects, which is difficult to do without “higher frequency” data (like liquidity)
- Study suggests that we need to revisit prior work

# Evidence-based regulation & cost-benefit analysis



- Most convincing studies from a research-design perspective have:
  - Thresholds (facilitate RDD)
  - Staggered implementation (mitigate concerns about concurrent events)
- See survey by Leuz and Wysocki (forthcoming JAR) for further discussion
- Ideally, thresholds and staggering are arbitrary
  - But that causes fairness concerns
- There are also significant costs to badly designed regulation and concerns about unintended consequences
  - So we cannot have it “both ways”

# Evidence-based regulation & cost-benefit analysis (cont.)

- If we are serious about economic analysis, then we should consider designing regulation with ex post analysis in mind
  - For instance, staggered introduction would make a huge difference
  - Example: OTCBB phased in the Eligibility Rule by ticker symbol
- Conduct field experiments and pilots
  - Should help with ex-ante analysis
  - SEC uptick rule study
- Regulation should also include mandates to collect relevant data and make it available to ex-post economic analysis
- We are still far from quantitative CBA
  - Ultimately, policymakers and regulators still have to make normative judgments