The Usefulness of Fair Value Accounting in Executive Compensation

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Content:
We investigate the effect of fair value accounting on the usefulness of earnings in executive compensation contracts. Our analysis uses a shock-based difference-in-differences research design that exploits the 2005 worldwide mandatory adoption of IFRS, and employs a firm-level measure of the fair value treatment effect. We find that earnings pay-performance sensitivity (PPS) declines among the IFRS adopters that are most affected by IFRS’s fair value provisions relative to the IFRS adopters that are least affected by its fair value provision. Our findings are consistent with the notion that IFRS, on average, improves the usefulness of earnings in executive compensation contracts, but that its fair value provisions offset this improvement among the firms most affected by those provisions. These results are primarily driven by firms in countries with strong enforcement, and are generally robust for industrial firms but hold only weakly for financial firms. We further find that increased earnings management, rather than increased earnings volatility, is the most likely channel through which fair value accounting impairs earnings PPS. Our findings contribute to the literature on the contracting usefulness of fair value accounting by presenting evidence that suggests fair value accounting impairs the usefulness of earnings in compensation contracts.

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All Interested are Welcome