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The relevance of the value relevance literature for financial accounting standard setting: another view ☆

Mary E. Barth[a], William H. Beaver[a,*], Wayne R. Landsman[b]

[a] Graduate School of Business, Stanford University, Stanford, CA 94305-5015, USA
[b] Kenan-Flagler Business School, University of North Carolina, Chapel Hill, NC 27599-3490, USA

Abstract

This paper explains that value relevance research assesses how well accounting amounts reflect information used by equity investors, and provides insights into questions of interest to standard setters. A primary focus of financial statements is equity investment. Other uses of financial statement information, such as contracting, do not diminish the importance of value relevance research. Value relevance questions can be addressed using extant valuation models. Value relevance studies address econometric issues that otherwise could limit inferences, and can accommodate and be used to study the implications of accounting conservatism.

JEL classification: M41; M44; G12

Keywords: Standard-setting; Value relevance; Valuation

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*Corresponding author. Tel.: +1-650-723-4409.

E-mail address: fbeaver@leland.stanford.edu (W.H. Beaver).

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1. Introduction

This paper offers a view of the relevance of value relevance research for financial accounting standard setting that contrasts with the view offered in Holthausen and Watts (2001) (hereafter HW). A key conclusion of HW is that value relevance research offers little or no insight for standard setting. As active participants in value relevance research and standard setting, our purpose is to clarify the relevance of the value relevance literature to financial accounting standard setting. Because we are discussants of HW, we only address issues raised in that paper. In particular, HW is limited in scope to a discussion of the relevance of the value relevance literature for financial accounting standard setting; it does not comprehensively review the value relevance literature. Accordingly, our discussion is similarly limited. A key conclusion of our paper is that the value relevance literature provides fruitful insights for standard setting.

This paper also clarifies several misconceptions articulated in HW regarding value relevance research. In particular, we make six points, which contrast with statements in HW. First, value relevance research provides insights into questions of interest to standard setters and other non-academic constituents. Although there is no extant academic theory of accounting or standard setting, the Financial Accounting Standards Board (FASB) articulates its theory of accounting and standard setting in its Concepts Statements. Using well-accepted valuation models, value relevance research attempts to operationalize key dimensions of the FASB's theory to assess the relevance and reliability of accounting amounts. Second, a primary focus of the FASB and other standard setters is equity investment. Although financial statements have a variety of applications beyond equity investment, e.g., management compensation and debt contracts, the possible contracting uses of financial statements in no way diminish the importance of value relevance research, which focuses on equity investment.

Third, empirical implementations of extant valuation models can be used to address questions of value relevance, despite the simplifying assumptions underlying the models. Fourth, value relevance research can accommodate conservatism, and can be used to study the implications of conservatism for the relation between accounting amounts and equity values. In fact, value relevance research is a basis for establishing that some financial accounting practices are perceived by equity investors as conservative. Fifth, value relevance studies are designed to assess whether particular accounting amounts reflect information that is used by investors in valuing firms' equity. Because "usefulness" is not a well-defined concept in accounting research, value relevance studies typically do not and are not designed to assess the usefulness of accounting amounts. Sixth, econometric techniques can be and are applied to mitigate the effects of common econometric issues arising in value relevance studies that otherwise could limit the validity of the inferences drawn from such studies.