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The relevance of the value-relevance literature for financial accounting standard setting ☆

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Abstract

In this paper we critically evaluate the standard-setting inferences that can be drawn from value relevance research studies that are motivated by standard setting. Our evaluation concentrates on the theories of accounting, standard setting and valuation that underlie those inferences. Unless those underlying theories are descriptive of accounting, standard setting and valuation, the value-relevance literature's reported associations between accounting numbers and common equity valuations have limited implications or inferences for standard setting; they are mere associations. We argue that the underlying theories are not descriptive and hence drawing standard-setting inferences is difficult. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Over the last decade numerous accounting papers investigate the empirical relation between stock market values (or changes in values) and particular accounting numbers for the purpose of assessing or providing a basis of assessing those numbers' use or proposed use in an accounting standard. We call the group of papers that are at least partially motivated by standard-setting purposes, the "value-relevance" literature. This paper's objective is to critically evaluate the standard-setting inferences that can be drawn from these value-relevance papers. The evaluation provides suggestions for future research for standard-setting purposes.

Our evaluation concentrates on the accounting, standard-setting and valuation theories underlying the value-relevance literature's standard-setting inferences. The reason is those inferences are likely to be useful to standard setters only if the underlying theories are descriptive (in the sense of explaining and predicting accounting, standard setting and valuation). Without descriptive theories to interpret the empirical associations, the value-relevance literature's associations have limited implications or inferences for standard setting; they are just associations. For example, consider standard-setting inferences based on a theory that assumes standard setters consider a "high" association with stock values a "desirable" attribute for accounting earnings. Those inferences are not likely to be useful *if* the evidence suggests standard setters do not consider stock value association an important attribute.[1] Simple assertions by authors that standard setters *should* consider that attribute desirable are not sufficient for scientific research. Those authors have to specify the objective of standard setting and how using the association criterion helps standard setters achieve that objective. If the specified objective and the association criterion do not explain or predict standard setters' actions, it is incumbent on the authors to explain (i) why standard setters do not pursue that objective and (ii) why pursuit of that objective is relevant and feasible.

In our evaluation we address some econometric issues that arise in value-relevance studies. We do it during our evaluation of the underlying theories rather than highlight the issues separately because solutions to econometric problems necessarily depend on the underlying theory.[2]

[1] Our paper reflects responses to drafts of the Barth et al. (2001a) commentary up to an including the draft dated January 2001. It does not reflect any differences in their comments between that version and the published version.

[2] Barth et al. (2001a, p. 90) note that "econometric techniques can be used 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". However, the choice of the appropriate technique for mitigating an issue requires an underlying theory.