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Comparative Value Relevance Studies: Country Differences Versus Specification Effects☆

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Abstract

This paper sheds light on the sensitivity of findings in comparative international value relevance studies regarding two fundamental methodological choices. We hypothesize and find that, first, using the regression vs. the portfolio returns specification and, second, the choice of the return window, is not arbitrary. Both choices will have an impact on country rankings and the significance of cross-country differences in comparative designs. This makes us conclude that findings in previous comparative international value relevance studies are partly driven by differences in market characteristics across countries. Extending the findings of Francis and Schipper (1999) and Collins and Kothari (1989), our results suggest that previous comparative studies might thus have overstated value relevance differences and institutional variables' power to explain these differences across countries. Findings are based on a treatment sample of 56,000 firm-year observations from 12 countries and from 12 matched U.S. control samples, with observations from 1988 to 2007.
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1. Introduction

Value relevance is a classical research design in market-based accounting research (Ball & Brown, 1968; Beaver, 1968). It aims at empirically testing the decision usefulness of accounting information. Thereby, it addresses one of the core functions that standard setters such as the Financial Accounting Standards Board (FASB) or the International Accounting Standards Board (IASB) assign to financial reporting.

Value relevance designs have been frequently applied in settings in which the usefulness of accounting figures is compared across countries, legal systems, or accounting regimes. While the first comparative international studies were published some 20 years ago (e.g., Alford, Jones, Leftwich, & Zmijewski, 1993), value relevance is still a popular research design, particularly in international accounting (Agostino, Drago, & Silipo, 2011; Clarkson, Hanna, Richardson, & Thompson, 2011; Devalle, Onali, & Magarini, 2010), potentially justified by a recent analytical finding that value relevance is better aligned with accounting quality than many other proxies (Ewert & Wagenhofer, 2011).

But there are also a number of opponents of such designs. Holthausen and Watts (2001) have questioned whether value relevance research can provide important insights for standard setters at all. Other authors have pointed to econometric issues such as appropriate scaling (Barth & Clinch, 2009; Easton & Sommers, 2003) or applying either the returns or the price model under the regression approach (Kothari & Zimmerman, 1995).

Indeed, the implementation of value relevance models requires a number of methodological choices. This paper addresses two of them that have, to our knowledge, not yet been extensively addressed in previous research, but are likely to play a crucial role particularly in comparative settings.

The first one is model choice between what is called the regression and the hedge portfolio returns approach — which represent different technologies to measure value relevance levels. Francis and Schipper (1999) have shown that the models are differently affected by changes in market volatility over time; hence, we suppose this issue to be particularly relevant in cross-country studies.

The second one is return window choice — the choice for a specific time window used to estimate capital market returns (as compared to the firm's fiscal year). Collins and Kothari (1989) have shown that return window choice may have an undesired impact on the firm-level assessment of value relevance in the U.S. Again, we consider this issue to be particularly relevant in comparative settings. Based on a sample of more than 56,000 firm-year observations from 12 countries with 12 matched U.S. control samples (1988 to 2007), this paper provides evidence that both choices indeed matter for findings in comparative studies.

We first reject the hypothesis that model specification (regression vs. portfolio returns approach) does not have an impact on the assessment of cross-country value relevance differences (H1). We detect substantial differences in rankings of all sample countries based on their R^2 and based on portfolio returns. We also find the significance of differences between treatment and matched control samples to vary under both approaches.

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