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Discussion of 'How can we measure the costs and benefits of changes in financial reporting standards?'

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Discussion of ‘How can we measure the costs and benefits of changes in financial reporting standards?’

Steven Maijoor*

Being invited to participate as a discussant on the topic of cost-benefit analysis gave me a sense of pride, as my dissertation in the 1980s was about this topic of cost-benefit analysis of accounting regulation or accounting standards. However, it was then emphasised in the invitation that I should not be here as an academic but be here as a practitioner regulator and that I should forget about what I had learnt in that dissertation and focus instead on the regulatory practice of evaluating standards and regulation.

This paper is in essence about the very important topic of how do you channel or transfer knowledge from research into practice? It is about the question: can there be any specific recommendation from research into practice, and what should be the way to conduct that? The cost-benefit analysis as it is conducted in welfare economics or public economics is the standard technique used to transfer this knowledge from research into practice, so I will reflect on that.

There are three parts to my discussion. I will first reflect briefly on the paper, but in essence I agree with most of the comments that Katherine Schipper made; and basically she did it in half an hour. It took me four years to come to the same conclusion as a PhD student! I specifically agree with her analysis and the point about the inconsistency between using the term ‘cost-benefit analysis’ and what is actually conducted by the standard-setters. Then I will briefly give you some information on how we, as the Authority for the Financial Markets (AFM), as a securities regulator, use economic analysis. Finally, I will have a few recommendations on the interaction between academia and practice.

First, it is very clear from the paper that the cost-benefit analysis as it is portrayed or suggested within welfare economics or public economics is not the way it is applied to financial reporting

regulation or financial reporting standards. There are many studies focusing on effects for capital market variables like market liquidity and costs of equity. There are also many studies on the effects for accounting numbers, but these cannot be considered as cost-benefit analyses. I agree with the point that regulators or standard-setters should be more transparent about what they are doing when they are conducting a cost-benefit analysis.

It seems to me that in the paper there are many arguments as to why it is too ambitious to have a cost-benefit analysis isolating the individual effects of standards on capital markets. It is extremely difficult to isolate those effects. Another reason for abandoning the ambition of a cost-benefit analysis is that if you look at many decisions in the regulatory world in the financial sector, they are partly based on fairness issues. As was also discussed in the presentation, fairness is not covered by a cost-benefit analysis.

I can give you some examples of those fairness criteria. Many decisions in financial regulation are based on investor protection, and reducing information asymmetry. So these decisions are not necessarily based on efficiency or cost-benefit considerations, but on equity or fairness considerations.

I will now discuss how the AFM, the securities regulator where I work, uses economic analysis in its policy-making. Within our budgeting process, economic analysis of our regulatory interventions is a regular accountability item. So when we report to the public, we need to conduct economic analyses of our interventions on a case-by-case basis.

The following three examples outline the type of studies that were conducted within the AFM environment. The first is the example of the so-called Market Abuse Directive, which is a directive focusing on insider trading, which is very similar to the fair disclosure rule in the US. This is also briefly mentioned in the paper. That is an area where the AFM received powers and sanctioning possibilities,

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and we looked at how that affected the cleanliness of the market and how it affected pricing in the stock market.

A second study, which was referred to in the presentation, is that we asked academics to do a study on the implementation of IFRS in the EU in combination with the implementation of enforcement of IFRS in the EU. The study was conducted by Christian Leuz, together with a colleague of his, Luzi Hail. They looked at the capital market effects of the implementation of the combination of IFRS and enforcement. It is clear that we cannot disentangle these two factors. They looked at the effects for the costs of capital, and the liquidity effects of the implementation of IFRS and enforcement in the EU.

Finally, a study that I am involved in at this moment is a study in the area of auditing oversight. It is part of our mandate since 2006. We had to select and license audit firms, and some did not make it in the first round. We investigated to what extent our assessment of the quality of audit firms is reflected in the quality of the financial statements of their clients.

These are some examples of outcome-related studies, and I fully support conducting those studies. Why? It is because we, as regulators, are primarily accountable in terms of our effectiveness. Effectiveness is extremely important as a regulator, in terms of 'Are we getting the outcomes that we are expected to get as a regulator?' I do not want to underestimate the administrative burden of regulations and oversight for companies, but in the end I think effective regulation is a much more important criterion than the administrative costs, also knowing that when regulations are not effective, the costs to society are enormous.

I now move to the final part on the interaction between academia and practice. As I said earlier, strictly speaking, the cost-benefit analysis should be the way to do it, but at the same time, as Katherine Schipper said, it is impracticable, and I think it is even impossible. But I value the studies on the effects on capital markets outcomes and accounting outcomes.

The fact that it is difficult to do those cost-benefit analyses is not a reason to be silent in a more policy-orientated debate. I observe some reluctance by academia to be involved in normative discussions. I would like to encourage academia to be more involved in policy-orientated and normative debates, of course after having done proper research based on evidence-gathering.

One example which is currently very important is the discussion about fair value, and the transparency objective of financial reports versus the prudential regulators' perspective; how do we combine those two objectives? That is an area that is very fundamental to accounting, and I would like to see more contributions from the academic community in this debate. Personally, for example, I was very much inspired by the article by Douglas Skinner in the *Journal of Accounting and Economics* in 2008 on how this worked in Japan and the Japanese crisis. I think there are important lessons from this study for the current debate about combining – or should we not combine? – the objectives of transparency, and regulating banks on the basis of the same set of financial statements.

To conclude, I agree with most of what is said in the paper. I think we should abandon the ambition of cost-benefit analysis but still use the academic expertise to collect evidence on the effects of standards and regulations.