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Table of Contents

FASB AND IASB CONVERGENCE: ASYMPTOTIC RELATIONSHIP OR TRANSMOGRIFICATION?

**Diane Satin, California State University
Thomas Huffman, California State University**

ABSTRACT

Much work has been done and many papers and articles written about the possibility of U.S. GAAP converging with the international financial reporting standards (IFRS) or at least of the U.S. firms adopting IFRS as an alternate reporting format for listed firms. This paper reexamines the discussion in light of the recent issue of ASC 606 (revenue recognition) and revisits several reasons that neither convergence nor adoption may be achieved. These reasons include the belief that U.S. GAAP is the gold standard for reporting, that too many groups and people are involved in the rule-making process, that there are too many choices for a resolution to the convergence issue, and that the innate belief that principles based and rules based statements are irreconcilable. The conclusion of this paper is that pure convergence will never be achieved, and that IFRS and GAAP will tend to grow closer as time passes, but asymptotically.

VALIDITY OF ALTMAN'S Z-SCORE MODEL FOR PREDICTING BANKRUPTCY IN RECENT YEARS

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ABSTRACT

Over the years, many models have been suggested and tested for predicting bankruptcy. These include ratio analysis models such as Beaver (1966, 2005), discriminant analysis models such as Altman (1968, 2006), regression models such as Ohlson (1980) and others. The Altman model (1968, 2006) is one of the most influential models in the area of bankruptcy prediction. However, the Altman model is not successful in predicting bankruptcy all of the time. The Z-Score predictive model, introduced by Altman in 1968, is a widely used and cited model for predicting bankruptcy, and uses a combination of several financial ratios to calculate the "Z-score", which value indicates the likelihood of future bankruptcy of the company under examination. Altman estimated the model using multiple discriminant analysis to derive a linear equation that discriminates between bankrupt and non-bankrupt companies. Multiple empirical studies have been done by Altman and others to evaluate the model. In this study, the Z-Score model will be evaluated using financial data from public companies that started reorganization proceedings under Chapter 11 of the bankruptcy code from 2000 to 2005.

The purpose of this study is to test the accuracy of Edward Altman's Z-Score model in a more recent time period from 2000 to 2005 including more recent years than in which it was developed and previously tested.

The question is whether the Z-score model is as accurate indicator for bankruptcy in a more recent period as it was in the 1960's and with a sample of companies from different industries. There have been several critiques of Altman's Z-score model. Grice (2001) addressed and questioned the generalizability of the model to industries and period outside of those in the original sample. When a model is applied to periods other than those used to develop and test the model; researchers assume the model is stable across economic conditions that change over time, such as inflation, interest rates, and credit availability.

The study took a large sample of companies that had declared bankruptcy during the period from 2000 to 2005. This sample of companies included companies from many different industries. Further the time period of the study was more recent from 2000 to 2005. The results from the study indicate that the Altman model predicted bankruptcy in a significant majority of the companies that subsequently declared bankruptcy. Thus it is still a viable predictor of bankruptcy.

THE PAYOFF OF PAYING IT FORWARD

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R. Samuel Sale, University of Texas

ABSTRACT

Unlike previous studies that examined companies based on their inclusion in indices or funds that featured companies judged to be socially responsible, this study attempts to determine if there is a measurable intrinsic financial value associated with public recognition of being a socially active company. It adopts an internal financial perspective examining several financial ratios of individual publically-traded companies that have been recipients of the Secretary of State's Award for Corporate Excellence (ACE). Comparisons between the company results and the company's industry median on four common financial ratios show no significant difference.

THE IMPACT OF DISCLOSING MANAGEMENT'S PAST FORECAST ACCURACY ON NONPROFESSIONAL INVESTORS' HEURISTIC DECISION-MAKING

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ABSTRACT

With the dramatic increase in the availability of personal investment websites and the increasing number of individuals choosing to manage their own investment portfolios (Looney et al. 2006), understanding the needs for, and uses of, publicly-available information by nonprofessional investors when making their investment decisions have become more important (Barron et al. 2004). The nonprofessional investor is challenged by the need to predict future earnings, stock returns, and risk (Moser 1989). In addition, behavioral research in finance and accounting indicates that, because of the inherent uncertainties in the decision-making process, investors often rely on heuristics (rules-of-thumb) when making investment decisions (DeBondt 1998).

Heuristics are decision rules which develop over time and are stored in memory (Chen et al. 1999). Their use is triggered by the receipt of heuristic cues which are information items related to the decision at hand. Heuristic cues used in investment decisions may include company name recognition (Teoh and Wong 1993), CEO reputation (Cianci and Kaplan 2010), and past stock prices (DeBondt 1998). While heuristic cues such as these can be helpful when making investment decisions, they can also lead to poor choices because they often don't have a direct relationship to the firm's earning potential or investment worthiness (DeBondt 1998).

The use of heuristics results in investors developing intuitions about their investment decisions (DeBondt 1998). This first impression (or initial preference), once formed, functions as a decision default (Chaiken et al 1989). The decision to stay with, or switch away from, the initial preference depends upon the strength of "constraint information" which is information that either contradicts the initial preference or supports an alternate decision (Simmons and Nelson 2006). Accordingly, as investors obtain additional information about the firms they are considering for investment, their initial preferences may be strengthened or weakened. Unfortunately, some types of constraint information related to investment decisions can be difficult for nonprofessional investors to use because the information may be difficult to interpret and/or access. An example of this type of information is management's earnings forecast.

A well-established literature stream has shown that management's earnings forecasts provide decision-useful information to investors (Waymire 1984; Pownall and Waymire 1989). From the individual investor's perspective, management forecasts provide forward-looking information that can be useful when predicting future cash flows. However, the interpretation of earnings forecasts can be difficult because its value is dependent, at least in part, upon the perceived reliability of the forecast. For instance, a reputation for highly accurate forecasting based on past disclosures increases the perceived reliability of subsequent management forecasts (Benjamin and Strawser 1974, Williams 1996). While knowing how accurate

management has been in the past is helpful, this information is often difficult to acquire because it is not currently a required disclosure. Thus, managements' earnings forecasts potentially represent an important source of constraint information, but the appropriate use of this information may be dependent upon the knowledge and/or experience of the investor.

The present study is an initial exploration into nonprofessional investors' use of managements' earnings forecasts. Specifically, we consider the impact of specifically stating managements' past forecast accuracy after investors have already established an initial investment preference. The experiment included 102 business students with limited investment experience assuming the role of nonprofessional investors. Each was presented with case materials describing two fictitious firms being considered for investment. Using heuristic cues such as CEO reputation, stock price trends, and brand name, the case materials presented one firm as the "intuitive" choice. After considering the heuristic cues, each participant indicated which of the two companies they initially felt was better. They also gave an assessment of their confidence in this initial preference. Participants were then given information on the accuracy of managements' past earnings forecasts. They were told that the management teams of both firms had either been very accurate or very inaccurate in making their forecasts in previous years. This manipulation resulted in two treatment groups: high accuracy and low accuracy. All participants then received current earnings forecasts for both firms. The forecasts presented to both groups indicated that the "non-intuitive" choice expected better performance. Participants were again asked which was the better company and indicated their confidence level. In addition, each provided a choice for the best investment.

Our results show that participants initially used the heuristic cues in ways consistent with prior research. Specifically, the firm with the trendy name, more accomplished CEO and higher historical stock prices was rated as the better company across both treatment groups. When considering the use of managements' earnings forecasts, we find a difference based on past forecast accuracy. For those in the high accuracy group, the forecasts appeared to moderate the participants' initial investment preferences and led them toward the non-intuitive option. In contrast, members of the low accuracy group continued to consider the intuitive option to be the better company, though the preference did weaken. Additional analysis shows that the low accuracy group also lost a significant amount of confidence in its preference. Overall, our findings suggest that managements' past forecast accuracy can play a role in how nonprofessional investors use earnings forecasts. However, the effect is not as straight-forward as was expected. The initial preferences were moderated by highly accurate forecasts, but less accurate forecasts had unexpected effects on strength of preference and confidence.

Our study contributes to the literature on investor behavior and financial disclosure in several ways. First, while many previous studies have focused on professional investors (e.g., analysts), we focus on the growing number of nonprofessional investors. This population of investors is worthy of study because the growth of online investing "increases the likelihood that the information they process will eventually be aggregated in share prices" (Barron et al. 2004, pg. 22). We also find support for earlier results by providing evidence that nonprofessional investors will rely on heuristics and heuristic cues in predictable ways when making investment decisions. Next, our study shows that management's past forecast accuracy can influence nonprofessional investors' interpretation and use of earnings forecasts. This finding highlights the importance of past forecast accuracy information being made readily available to these investors. Finally, our participants' unexpected reliance upon less accurate forecast information certainly calls for further investigation.

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MANAGEMENT DISCRETION OF ACCRUALS PRIOR TO THE DEMUTUALIZATION OF PROPERTY-LIABILITY INSURANCE COMPANIES

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ABSTRACT

This study examines whether management of property-liability insurance companies use their discretion in estimating the claim loss reserve in the year preceding demutualization. Since valuation of a mutual insurance company is a critical component of the conversion process I posit that the incentive to manage surplus by either overstating or understating the insurer's largest accrual, claim loss reserves, is dependent on management's role subsequent to the conversion process. If management has a significant role (i.e., principal shareholder) after conversion, the incentive is to overestimate the loss reserves to transfer wealth from policyholders to themselves. The regression for 53 property-liability insurance companies that demutualized identifies that claim loss reserves are overstated as a means to decrease surplus and that a significant role by management in the post conversion company provides the incentive to overstate the loss reserve in the year preceding the conversion. The study provides an opportunity to study the impact of the regulatory process on management discretion in loss reserves, provides further insight into the demutualization process, and extends earnings management research. Finally, while prior literature identified stabilization of earnings and avoidance of regulatory intervention as reasons for management discretion in loss reserves, this study documents management of policyholders' surplus for management benefit, as an additional effect of discretion in the reserve estimate.

EMOTIONS AND INVESTMENTS

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ABSTRACT

This paper provides a review of factors influencing and enhancing the decision making process in investments. When faced with the state of uncertainty prevailing in the market investors may aim for minimizing regret from their actions. This appears to be as a result of reflexive responses, feelings and emotions as well as reflective processes. In particular, understanding, managing and regulating emotions appear to help in the decision making process.

INTRODUCTION

In the context of the modern financial economics investors are assumed to possess a rational behavior, acting on the basis of maximizing their expected utility of final wealth in a market that is characterized with the availability of complete information regarding the payoff structure of financial assets. This implies that the average return and the likely fluctuations around it are known in advance and the distribution of returns follows a normal curve. Furthermore, investors are assumed to be risk averse and thus would be willing to invest as long as the average payoff consists of a reward adequately compensating for the risk involved.

An investor who is risk averse is expected to take a risky venture when the rise in wealth is expected to be greater than the fall in wealth. While the pleasure of gaining a dollar, on average, is less than the suffering from losing a dollar, investments are made as long as there is a net premium or reward for taking the risk involved.

The development of the behavioral finance during the past three decades has however shown that investors may possess a loss aversion behavior and aim for avoiding the decline in wealth. Investors appear to sell financial assets that have risen in price too quickly while keeping the loss producing ones for a long time. That is, investors react differently to gains and losses as they feel positive emotion from a gain in price but a much stronger negative emotion from an equal amount of loss. In the mind of an investor a dollar gained in the retirement account does not cancel a dollar lost in the personal account.

Furthermore, investors view a dollar received in dividend income differently from a dollar gained in capital gain even in the absence of differential taxes and transactions costs as they appear to consume the dividend while saving the capital gain. The feeling is that earning the capital gain had required more effort—taking more risk—as compared to the predictable stream of dividend income (Kahneman and Tversky, 1979; Thaler, 2000 and Statman, 2010). This view is different from those in the neoclassical finance as for example in Modigliani and Miller's (1958) irrelevance of the dividend policy of the firm as the dividend income and the capital gains are assumed to have the same value for the investor in the absence of differential taxes and transactions costs.

Emotions, intuition, and gut feeling appears to be an integral part of thinking and decision making and tend to raise the capacity and in the speed of actions by combing the reflective and reflexive parts of the brain. In a market characterized by conflicting signals money managers may form an opinion based on the likely actions of others by increasing the state of knowledge and gaining information advantage by the merits of signals transmitted by business enterprises. In this

process Tuckett and Taffler (2012) believe that money managers form an emotional relationship with their investments tantamount to love and hate depending on the outcome.

Zweig (2010) states that emotion may override cognitive and analytical reasons in the decision making process and is contagious in the market. Emotional reactions of losing money for example is based on the function of amygdala in the brain as the risk perceived by the reflexive part of the brain, which will lead to a fast response in deciding to sell. As many people appear to share the same information, the intensity of selling will rise and lead to a sharp decline in price.

CONCLUSION

Emotional intelligence complements the theories formed in behavioral finance. Ameriks, Wranik and Salovey (2009) examine the role of emotions in the investment decision making process. They study the degree to which investors identify, understand, interpret and effectively use their emotions and find that emotional intelligence will add value in decisions with uncertain outcome.

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