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Better Financial Reporting: Meanings and Means

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Overview

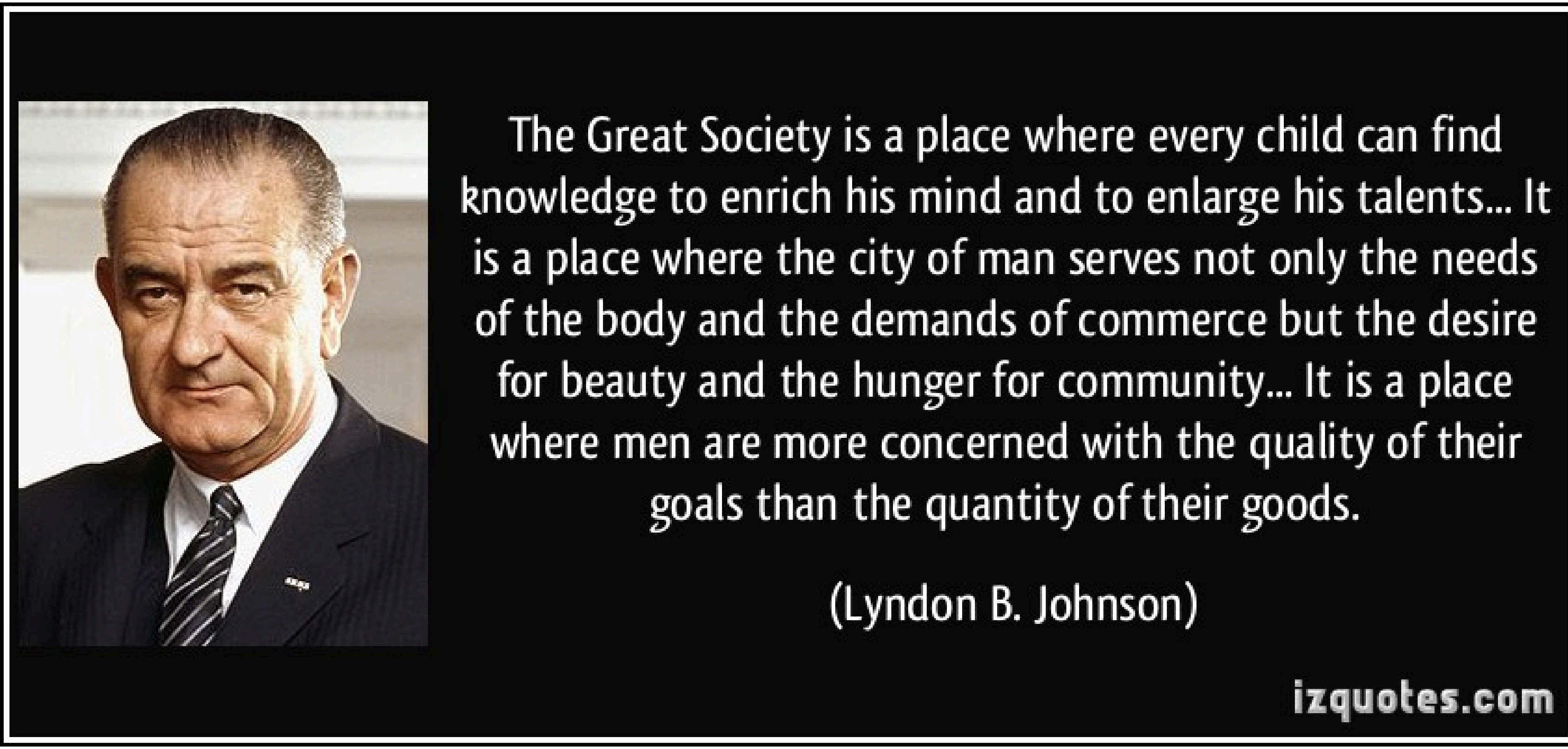
- What could be the meaning(s) of better corporate financial reporting?
- Conflicting elements point to the political aspects of collective choice
- Means of getting to “better” in some agreed upon sense
- Perhaps some judicious combination of
  - Regulation
  - Social norms
  - Market competition
- If so, how do we develop such institutions?

What is Better?

- "…high quality standards…" without specifying what it means (in a discipline devoted to measurement!)
- Consider four approaches
  - Efficacy of financial reporting in serving broad societal functions
  - Attributes of financial reporting (desirable and undesirable)
  - One or more classes of participants whose purposes are to be served by financial reporting
  - Some measurable statistical properties of the data generated by the reports

Meanings: Serve Societal Goals/Functions

- Creation of wealth and livelihood
- Promotion of social cohesion and justice
- Creation of markets for physical, financial and human capital that promote economic efficiency
- Creation and operation of organizations to create and distribute social surplus
- Coordination and disciplining of individual participation in organizations and society so personal pursuits do not overwhelm their collective functions
- Discipline alternative and competing sources of information to add stability and predictability to organization.
- Reduce organizations' cost of capital (?)


The Great Society is a place where every child can find knowledge to enrich his mind and to enlarge his talents... It is a place where the city of man serves not only the needs of the body and the demands of commerce but the desire for beauty and the hunger for community... It is a place where men are more concerned with the quality of their goals than the quantity of their goods.
(Lyndon B. Johnson)
izquotes.com

Meanings: Attributes

- faithful representation
- Timeliness
- Relevance
- Reliability
- Verifiability
- Uniformity
- Consistency
- Comparability
- Cost-benefit efficiency
- Conservatism
- Robustness to manipulation and fraud
- Governmental organizations: transparency, public accountability, and citizen empowerment and engagement with the organization

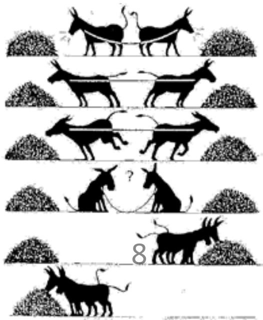
Meanings: Attributes

"Everything's a tradeoff — now that I can walk upright, I can't wiggle my ears any more."

- Three caveats:
  - No guidance for trade-offs: e.g., faithful representation and timeliness; relevance and reliability
  - Conflicts on desirability among prepares, auditors, and users
  - Ambiguity of meaning: e.g., uniformity, comparability, and conservatism
    - Obvious at distance, not in close scrutiny
    - What does uniformity mean in a multi-attribute world?
    - What does comparability mean in a world where no two transactions are exactly alike?

Meanings: Serve Individual Goals

- Enabling participants in an organization to make better informed private decisions to improve their individual welfare
- Four sources of ambiguity:
- Diverse goals and information demands of groups of participants; may include diametrically opposed interests.
- Needs of individuals depend on personal circumstances, change dynamically, unknown and unknowable to others
- Assumes no interaction among their decisions
- Demski (1973): Blackwell's fineness condition for informativeness; not likely to be met by any standard, except by Sorter's (1965) events approach



Meanings: Serve Individual Goals

- Simplify by narrowing focus on serving a single group
- Oft-favored group: investors, even shareholders
- Vast literature using the “shareholder perspective” on merits of financial reporting rarely articulates its rationale; venture some guesses:
  - Milton Friedman’s widely misunderstood dictum “profit is the only goal of business”
  - transformed into “maximizing shareholder value
  - Sometimes transformed into maximizing share price
  - The long leap to: “maximizing share prices is the goal of financial reporting regulators/standard-setters.”
  - But shareholders not the only group in society with relevant interests
  - Informing shareholders for better investment decisions is not the same thing as financial reporting that will increase stock prices and returns
  - Enron example

Meanings: Producing Data and Disclosures with Desired Attributes

- Correlation between financial reports and stock market data; “value relevant” reporting; problems with value relevance
- Include consolidation of controlled entities
- Include separate business and geographical segments
- Include quarterly results
- Disclosures: financial instruments, off-balance sheet financing, uncertainties, and separate core from non-core businesses
- . In 1994 AICPA’s Jenkins Committee: financial and non-financial information
- Inclusion of forward looking information in financial reports under safe harbor rule, and the consequences

Meanings: A Summary

- "Better" in financial reporting means many things:
  - meeting specified societal or individual goals, or
  - possessing some general qualitative or specific statistical attributes and disclosures
- Difficult, even at a conceptual level, to obtain agreement on what kind of financial reports do or can meet criteria within any one of these four classes, much less all four. What can be done in absence of broad agreement?
- Given the nature of collective choice and social policy, it is rare for any attempt to clearly identify better financial reporting. Trade-offs must be made in presence of non-commensurate and conflicting within- and across-person objectives. The absence of even reasonable data on preferences, costs and benefits lead to ambiguous conclusions. Indeed, it is a challenge to be both knowledgeable and confident
- Fortunately, such divergence in social policy not unique to financial reporting;
- Look at aspects of economic life outside accounting for help
- Analytical derivation of solutions to problems of collective choice is difficult
- Alternative: look at the processes; develop a socially acceptable process for defining and developing financial reporting

Means

- Over millennia, human societies have developed and employed a variety of social choice mechanisms to solve such problems
- Standards written by a regulatory body are the most frequently employed and analyzed mechanism in the domain of financial reporting
- But not necessarily the best mechanism for all aspects of financial reporting
- Consider the characteristics of the available alternatives:
  - common law
  - popular vote or referendum
  - Legislation and statutory law
  - Courts
  - administrative-regulatory agency
  - self-regulation
  - Markets
- In practice, two or more may be used in parallel.

HENRY II ATTEMPTS TO INVENT THE COMMON LAW

Common Law and Social Norms

- Common law, like language and other social norms
- Emerges from the grass roots
- Most diffused of collective choice mechanisms with minimal role for a centralized authority
- The process of emergence not well-understood
- Does not conform to the demands of a defined time table
- Only matters of broad principle not fine-grained distinctions and technical details beyond the capacity of non-experts.
- Paciolo's text codified the prevailing accounting practices of Italian merchants
- Captured the “common law” of accounting
- Phrase “generally accepted accounting principles” reflects the common law origins of accounting
- Financial reporting largely left this common law until the number and size of publicly owned business enterprises grew
- Demands of growth of larger complex publicly-traded organizations in manufacturing, transportation, utility, and service industries
- Limitations of the common law approach
- GAAP capitalized and appropriated by corporate bodies with legal aut make and impose top-down rules on reporting entities

Popular Vote or Referendum

- Individual citizens have the chance to indicate their preference directly
- May work well social decision mechanisms when the citizens can be presented with just two, or no more than a few, simple, ready-to-understand alternatives such as “X or Y” or “Yes or No”
  - Permitting legalized gambling, sale of alcoholic beverages, and caps on real estate taxes
- As the number and complexity of alternatives increases, efficacy of popular vote is diminished
- Most citizens do not have the knowledge to make an informed choice
- Formulation of alternatives presented to the citizens itself becomes important, and cannot be handled by referenda
- Voters do not comprehend the implications of the collective choice at stake, they become more susceptible to suggestions, advertising, and demagoguery
- Not surprising that financial reporting choices are not made by this method

Legislation and Statutory Law

- Statutes are a result of top-down decisions of the ruling dispensation
- In democracy, representatives legislatures formulate, debate, and approve statutes with sufficient support
- “No legislative action” is also a choice, often exercised
- Members of legislatures can argue for the interest of their own or constituents
- Advantage: conflicting interests are articulated, debated, and bargained on in open
- Broad responsibilities of legislatures legislators cannot become knowledgeable about technical complex issues such as financial reporting
- Legislators tend to leave the details to staff
- In the 1990s, US Congress involved in accounting for executive stock options; years for US financial reporting to recover from that intervention
- French government’s intervention with the International Accounting Standards Board in the wake of accounting problems at Societe Generale
- The title of Romano’s (2005) paper “Sarbanes-Oxley Act and the Making of Quack Corporate Governance” is an indication of serious doubts about the wisdom of legislative intervention in the specifics of financial reporting.

Courts

- Unlike legislatures, judges must take a neutral stance
- Under pressure of the arguments from two sides they decide on the basis of law not personal preferences
- Violation of this judicial norms: risk of reversal, loss of public esteem
- Legislators may consider multiple alternatives; courts have two sides
- Courts must decide one way or the other; they cannot punt
- Spacek (1958): proposed a specialized accounting court
- Expertise to handle the finer points and technical details
- Able to use common law to make judgments on financial reports being "true and fair"
- Analogous to determination of "guilty beyond reasonable doubt" in criminal courts
- Reduce administrative and regulatory burdens of making and enforcing rules
- Spacek's proposal did not get traction in the accounting, business or regulatory communities
- Administrative and regulatory approaches to addressing problems of financial reporting have remained and grown in their dominance. Why?

Administrative and Regulatory Agency

- In 1930s, US Congress enacted securities laws, responsibility for regulation of publicly traded companies' financial reporting to the SEC
- Commissioners exercise independence from the government
- Answerable to US Congress for implementing the laws
- Effective regulation (e.g., of insider trading),
- Innovation and experimentation with regulatory methods (e.g., accounting for inflation and for oil and gas exploration)
- Dismal failures (e.g., Enron, WorldCom, Global Crossing, etc.)
- Administrative approach to regulation: worked well with exercise of discretionary powers and judgment in public interest (staffed by angels!); insider trading example
- Contrast with Japan; written rules become road maps for evasion.
- Dilemma: if write only general principles, allowing room for judgment in enforcement
- Defense complains about the lack of specificity in the principles, calls for clarification or "guidance"
- Clarifications shift principles towards in the direction of rules, open new loopholes
- Detail and complexity gradually inches up on demand from the regulatees, reducing scope for judgment on general principles
- re to follow this process attracts charges of arbitrariness and absence of due ess in a democratic polity.

Self-Regulation

- Allows a profession or industry to create and operate its own system to regulate and discipline its members
- Most professions have such organizations to set standards, monitor quality and performance, and take punitive actions
- More effective in creating coordination standards because they tend to be largely self-enforcing (examples)
- Not true of quality standards, incentives to cut corners by free riding on industry reputation, when quality not easily observable
- Self-regulatory organizations concentrated in coordination work, and government standards play a stronger role in quality standards (see Jamal and Sunder 2008).
- Self regulation encouraged in US over eighty-years CAP, APB, FASB)
- These organizations worked closely with SEC’s Chief Accountant, and rarely issued rules without their pre-approval
- Under this arrangement, following the preparers’ constant demands for clarification, the body of written rules that are now supposed to constitute the “Generally Accepted Accounting Principles” has grown to some tens of thousands of pages.

Markets

- Absent externalities, with sufficient competition, markets efficiently direct production and allocation of private goods
- Information in financial report fulfills the two properties of public goods
- Out-of-pocket cost of preparing the reports plus cost of regulatory compliance and induction on decisions
- Point to addressing it as a collective and not as a private choice problem
- Collective choice mechanism does not automatically resolve the difficulties of identifying better reporting methods
- Can conceive of a system of competition among alternative sets of rules by which markets operate (e.g., stock exchanges, environmental regulations, educational systems, etc.); alternative sets as private goods--a fee or tax from those who choose to be participate
- Fewer people involved in centralized systems; more power of state; decisions can be made and enforced more expeditiously
- Chances of serious errors increase
- Historically US, and more recently EU, have pursued centralization
- Why the prevailing dissatisfaction? Is there dissatisfaction?

What is missing in the meaning of better financial reporting

- Stability
- Emergent
- Robust to financial engineering (Sorites Paradox)
- Learning systems
- Suited to local business and legal environment
- Recognize endogeneity of transactions complexity
- Active engagement of academics with issues and debates (John Bourn)

Balancing Regime for Improving Financial Reporting

- Regulation and standards vs. culture and social norms
- Specificity vs. purposefully ambiguity
- Threshold vs. continuous approaches
- Authority vs. competition
- Privacy vs. open transactions database (Sorter's "events" approach)
- Confidence in designed social systems vs. some humility

Concluding Thoughts

- Standards are not just a technical matter
- Technical expertise necessary but not sufficient
- Standards in all fields must consider efficiency (a technical matter) and distribution of wealth (a political matter)
- Politics: people can differ without any one being wrong
- Quasi-judicial structure of the FASB/IASB, combined with a large technical staffs, tend give a technical flavor to its task; reluctance of FASB to acknowledge the political aspects of its charge (Morley: they knew better)
- Quasi- legislative system will place greater emphasis on the political charge, technical competence remains necessary
- Appointment of “disinterested parties” (e.g., accounting professors), who presumably have no identifiable political interests as a class in setting of accounting standards, to a standard-setting body tends to detract from the political aspects of its task; become ideological
- They can provide advice and technical support without being given a vote

Concluding Thoughts

- No standard is indispensable; people adjust and live without standards
- Issuance of a bad standard can do damage
- How to assess performance standards setters? Biased towards action?
- We do not judge legislatures by the number of enactments
- Refusal or delay to issue new standards is not a weakness
- Let them take time, conduct field studies, and make comparisons
- Our ability to identify socially superior solutions remains, limited and imperfect
- We cannot observe others' preferences; depend on their knowledge, experience, and change
- People, with the help of financial engineers, adjust their behavior to new situations and standards
- Understanding or observation of these changes takes time
- Aggressive standard setting, not based on practice, has costs
- Given the experience so far, some modesty with respect to our ability to devise new accounting methods that improve financial reporting may not be out of place

Perspectives

Thank You.

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