

# THE ROLE OF FINANCIAL REPORTING: DISCUSSION

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S. P. Kothari's paper is a useful synthesis of some recent research addressing policy questions of international (or global, cross-border, multinational) financial reporting. The stream of research covered is of relatively recent origin in major accounting research journals. Until about 10 years ago, robust research in this area was sparse because of limited data availability, absence of testable analytic models, and questions about the general relevance of such research. Thus, there is a paucity of earlier research that might serve comparative or time-dimensioned purposes. Purely descriptive international accounting research has been published since the 1960s.

Eight central propositions are put forward in Kothari's paper, on each of which I will present a brief commentary. The identification of these propositions is mine and not the author's.

1. "Reduced information asymmetry has desirable effects on the cost of capital and the volatility of security prices" (p. 90).

The direct linkage asserted in this proposition has not been established by robust research, even though it is generally assumed to be valid. Variables affecting both the cost of capital of individual firms and the volatility of security prices are numerous, constantly changing, and difficult to specify for control purposes in research designs.

Influential financial market leaders have put it thus: "The single most important innovation shaping the American capital market was the idea

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of generally accepted accounting principles” (Lawrence Summers); and “Transparent accounting plays an important role in maintaining the vibrancy of our financial markets” (Alan Greenspan). Albeit indirectly, these expert opinions support the proposition advanced here.

2. “The quality of reported financial information, however, is influenced not simply by the quality of accounting standards, but also by other institutional factors [corporate governance, the legal system, and the existence and enforcement of laws governing investor protection and disclosure standards] that affect the demand for and the supply of financial information” (p. 90).

“The quality of financial information users receive is a function of both the quality of (accounting) standards governing the disclosure of accounting information and the regulatory enforcement or corporate application of the standards in an economy” (p. 92).

“[I]f enforcement of shareholder rights and disclosure standards is weak, then the quality of disclosure tends to be poor, regardless of the disclosure standards” (p. 95).

The theme echoed in the foregoing quotes from the paper is essentially the crux of the entire argument, that is, accounting and reporting standards alone, even if they are of the highest achievable quality, are not sufficient. A “well-oiled” comprehensive international financial reporting infrastructure is necessary. This imperative is posited in FASB’s *International Accounting Standard Setting: A Vision for the Future* (1999) as well as the SEC’s *Concept Release: International Accounting Standards* (2000). My co-discussant, Marisa Lago, elaborates on the SEC Release.

3. “There appears to be near unanimity among regulators and investors in their demand for high-quality financial reporting, because of the widespread belief that the quality of financial reporting directly affects capital markets” (p. 91).

Similar to the assertion made in the first proposition I identified, a direct (and positive) market linkage is posited for high-quality financial reporting. Such is not unequivocally demonstrated by extant research. In fact, SEC Chief Accountant Lynn Turner requested research of this type from members of the American Accounting Association (AAA) in a letter to AAA 1998–1999 President Michael Diamond dated August 15, 1999.

But expert opinion seems near unanimous. The FASB Chairman, Edmund Jenkins, has stated, “A clear connection between the efficient and effective U.S. capital markets and the high quality of U.S. financial reporting standards is evident.” Likewise, Abby Joseph Cohen, the highly respected Goldman Sachs market strategist, has said, “The quality of

information we now receive from companies in the United States is about the best we have ever seen and dramatically exceeds that of almost any other nation.”

4. “[A] precise definition of quality or transparency that everyone agrees on has been elusive” (p. 91).

It not only “has been” but still is elusive. Research on this point is one of the requests made by Turner in his letter to the AAA. At FASB we devoted time at two successive AAA/FASB Financial Reporting Issues Conferences (1997 and 1998) to this topic. All said and done, the FASB *Statements of Financial Accounting Concepts* (latest edition) contain extensive discourse about and specific factor identification of *Qualitative Characteristics of Accounting Information* (Statement of Concepts No. 2). Regarding those characteristics, Statement No. 2 asserts, “It is those characteristics that distinguish more useful accounting information from less useful information.” Thus, for the time being, FASB standard-setting utilizes conformity with its conceptual framework as the metric for standards quality. Thus, high conformity with established concepts indicates high quality of standards (underlying financial reporting).

5. “The government enforces the code law.... Common law is enforced privately, through civil litigation” (p. 93).

Categorizations of financial markets and financial reporting quality and infrastructure have begun to blur. Germany and Japan have strict code-law legal systems, but the former established an independent financial accounting standards-setting board late in 1998 and the latter is about to do likewise. The United Kingdom is a common-law country, but her membership in the European Union (EU) subjects her to significant code-law incursions. For most intents and purposes, the dichotomy between these two legal systems is no longer as crisp as it was even recently. Thus, basing financial reporting policies and the financial accounting standards supporting these policies on legal system differences is increasingly less supportable.

6. “Demand for public disclosure is high in the case of diffuse-ownership corporations, whereas demand for disclosure is muted in the presence of concentrated ownership” (p. 99).

Whereas this proposition is intuitively obvious, it raises an important policy implication. Should we have two sets of financial reporting structures—one for diffuse ownership and another for concentrated ownership? In the United States, we have answered this question with a “No.” Even though the SEC has no jurisdiction over privately held companies, such entities must still comply fully with (general purpose)

GAAP if they wish to receive the unqualified audit opinions possibly needed for bank loans, industry regulatory requirements, or mergers and acquisitions activities. The “muted demand for public disclosure” in countries where corporate ownership is by-and-large concentrated (Switzerland in Europe, most of the Near and Middle East, and most of Asia and the South Pacific) appears to have stifled local capital markets and caused widespread misallocations of economic resources. From the evidence to date, the policy case for differentiated financial reporting structures is weak.

7. “With or without good enforcement of investor protection laws and disclosure standards, the case for high-quality, mandated disclosure standards is surprisingly weak” (p. 99).

“Should the [accounting] standards not be of high quality, corporations will engage in voluntary disclosure to meet the demand for public disclosure” (p. 100).

This argument is contentious on two points. It is clear that without “good enforcement” even the best accounting standards will be inconsequential. Again, this is one of the core aspects of the SEC’s *Concept Release* addressed further by Ms. Lago. But even in jurisdictions lacking “good enforcement” (there is no SEC in any other country around the world), do we not need benchmark standards and reporting structures as points of departure? Possibly comparison standards exist only in other jurisdictions, yet the reciprocal effects between enforcement and high-quality standards suggest concurrent development of both, where either is lacking.

Will voluntary disclosure fill any gap left by subpar accounting standards? Selectively, yes—generally, probably not. Voluntary disclosure is entity-specific and fully at the discretion of management. Good news is quickly and fully disclosed in such cases—bad news is not (think of Asian financial institutions during the past decade or so). In a voluntary disclosure regime, users of financial statements never know the quality of what is reported, let alone what remains undisclosed. Professor Fred Choi (NYU) developed the “Competitive Disclosure” axiom in the late 1960s. It holds that effective voluntary disclosure is an overlay to a known and mandated standards/financial reporting structure.

8. “[S]tandard-setting decisions should take into account institutional factors and the quality of law enforcement in an economy, rather than be taken on standards in isolation. A simultaneous push for greater shareholder protection and transparent accounting standards is warranted” (p. 101).

This concluding statement elicits from this discussant a resounding rejection of its first part and full acceptance of the second. If institutional

factors and the quality of law enforcement were to become determinants of accounting standards, the latter's neutrality would be lost, the process necessarily would have to be politicized, and global standard-setting would be rendered futile. In fact, we would then have differing national or even sectional accounting standards. As Kothari points out in other portions of his paper, such a regime would have seriously negative consequences on the effectiveness and efficiency of financial markets worldwide. On the other hand, one can readily agree that greater shareholder protection and transparent (high-quality?) accounting standards go hand in hand.