FAT Wk 12 – Voluntary Disclosure and Regulation
To conceptualise accounting information as a commodity for markets
To explain the arguemtns for private vs regulated markets for accounting information
To understand the incentives for disclosure/signaling

Fundamental problem of financial accounting theory

- 2 primary objectives
  - Valuation
  - Stewardship/Efficient contracting
- How to produce *optimal* amount of information?
- Is regulation necessary? If so, how much?

Market forces and regulation

- Information is a kind of "commodity" – produced by firms (*preparers*) and demanded by decision makers (*users*)
- Different information (commodity) have different characteristics that decision makers (users) want
- E.g. managerial forecasts, beyond required disclosures, voluntary disclosure can be very useful information.

Information production

- What is the optimal amount of information from society's POV?
  - Firm should produce info until <u>marginal social cost = marginal social benefit</u> (cost benefit equalizes)

Benefits of information production		**Costs** of information production	
1. Improved individual decisions	<u>Of investors and Of managers</u> - They do not have insider info – information asymmetry, creates adverse selection problem. - If no financial reporting, investors may discount future CF it to a great extent because of higher risk due to the lack of info → COY will get less capital, higher cost of capital - Therefore, to get lower cost of capital, to reduce the risk, disclosure will help. And eventually increase firm value. - Disclosure will be beneficial to firm and investors - Managers will need information to make transactions, sales and purchases, investments, etc. …	1. Out of pocket costs	<u>Time and effort, Information systems</u> - Auditing services, 3^{rd} party to make information more credible to S/Hs, to investors because mgrs. are held responsible for the COY's Net Income. So 3^{rd} party needed to attest to the info's credibility - Audit engagements are very expensive for the firm
2. Improved operations	<u>In capital markets</u> - Capital markets demand information – adverse selection problem. <u>In managerial labour market</u> - Use of managerial labour market to discipline managers	2. Proprietary costs	<u>May reveal information to competitors</u> - Cost incurred to publicly disclose competitive information that will put the firm in a competitive disadvantage - Have a direct effect on the firm's future cash flows

	- Disclosure can help improve manager's reputation – shows that they have performed well			
			3. Contracting costs	e.g. great earnings volatility due to fair value accounting - Cost of information production - Most firms produce financial reports based on HC accounting - but there are disadvantages to using HC accounting - But alternative method also has its own disadvantages - But producing both also have their own disadvantages - If mgrs. are held for things beyond their control, they have increased compensation risk, therefore, demand for higher compensation → contracting cost increases, not efficient contracting

Information and Standard setting

- Accounting Standards and Boards exists – IASB, AASB, FASB
- 2 views
  - 1. We need regulations to produce the right amount of information
  - 2. We don't need regulation; we need free market – market incentives to produce the right amount of information
- Without accounting standards, will there be a **free-market solution**?
- **Ronald Coase** – **Coase Theorem** – basically says that we don't need regulations, bargaining can solve the problem and produce the right amount of information
  - According to the theorem, the parties affected by an externality will bargain to reach an outcome that will be more efficient.
    - ***Externalities***: cost or benefit that affects a party who did not choose to incur that cost or benefit.
      - E.g. of negative externality – pollution. Firm has negative externality on other users in the environment.
      - E.g of positive externality – financial reporting. Firm will produce info that is beneficial for the firm itself, S/Hs and for the economy.
  - However, transaction costs must be low for parties to arrive at a more efficient outcome.
    - In reality, transaction costs are rarely low, therefore, this theorem is often inapplicable
  - Bargaining can be used to solve the externality problem – free bargaining is possible

Coase Theorem Examples:

Carol's fishery affected by ABC COY's river pollution. Fishes die, they catch less fishes.
Net social benefits are different with pollution control and without
- With control, ABC have lower net benefit
- Without, ABC have higher net benefit
- So, Carol's Fishery can pay ABC $30 to offset their losses from implementing the pollution control and still make a ($50-$30) = $20 gain
    - In absence of regulation, best outcome can still occur

	Pollution Control	No Pollution Control
ABC's net benefit	$100	$130
Carol's net benefit	$100	$50
Total social benefit	$200	$180

Some information are costly and will not have direct benefit for the firm but will directly benefit users – positive externalities
- Firm's disclosure results in -$100
- Bargaining between users and preparers will occur
- Users will pay $100 to production of info, but User will still gain $50 as net social benefit from the disclosed information
- Therefore, we don't need regulation to mandate the amount of information to produce.
- We can rely on Coase Theorem, assuming minimal transaction cost, to achieve optimal information production.

	Acct Info Production	No Production
Firm's net benefit	$ -100	$ 0
Investor's net benefit	$ 150	$ 0
Total social benefit	$ 50	$ 0

Private incentives for firms to disclose information

- **Contractual incentives**
    - **Compensation contracts** – performance measures need information to indicate manager's effort/performance e.g. net income
    - **Debt contracts** – debt covenants need information to secure debt financing at a lower cost (due to lenders having more trust, so charge less interest), prevent costly debt covenant violation e.g. D/E ratio, working capital
- **Market based incentives**
    - **Securities market** – poor disclosure creates estimation risk (adverse selection) which increases cost of capital
    - **Managerial labour market** – poor disclosure lowers managers' market value/reputation, market penalizes manager for poor disclosure
    - **Takeover market** – poor disclosure increases estimation risk, leads to manager being replaced

Estimation risk refers to investor uncertainty about the parameters of the return or cashflow process.

    - Evidence that market rewards good disclosure/full disclosure
        - **Merton, 1987** – better disclosure leads to **better diversification**
        - **Diamond & Verrecchia, 1991** – better disclosure **increases market liquidity and share price**
        - **Easley & O'Hara, 2004** – better disclosure **reduces estimation risk**
- **Disclosure principle**

  - Market knows manager has the information so when manager does not release this information, market will fear for the worst (investors are risk averse) → share price crashes, manager may be penalized by the firm for this share price volatility or share price fall
  - Therefore, to avoid this problem, manager should do <u>**full disclosure**</u>.
- **Signaling** – important because it's very useful for everyone
  - High type vs Low type
    - High types want to be distinguishable from the low types
  - <u>Crucial aspect of a signal is for high types to be less costly to signal</u> i.e. must be high cost to signaler if the information is untrue
  - Financial accounting policy choice as a type of signal

Effective signals/signaling

- **Issue of ESOs** – cost of signaling will be low if info is true because share price will increase and managers will benefit
- The **proportion of equity retained at IPO**
- **Adoption of conservative accounting** – a signal that mgrs. are confident of firm's future because conservative accounting systematically understate earnings. So, if mgrs. are confident that even with this systematic understatement, they can still report high earnings, indicates that the firm has good potential. *Low types* can't do that, high cost to them because it will make their earnings worse.
- **Reporting excess positive accruals** – if signaling is untrue, it will be costly. If true, these accruals are reversing, will reverse over time, low cost to *high types*.
- **High quality, good news forecast** – if untrue, market will punish managers, high cost to managers.
- **Retention of a high-quality auditor**
- **Debt financing**

Are private incentives sufficient?

- *Coase* recognized that contracts break down if too many parties are involved – the cost of bargaining are just too high.
  - Too many parties involved, cost of transaction increases, cost of bargaining increases, theory fails to hold.

Market failures in private information production

- **Free markets** may not be completely effective
  - <u>Private and social value of information is not the same</u>
    - **Externalities problem** – where an action taken, by a firm or individual, that imposes costs or benefits on other firms or individuals for which the entity creating the externality is not charged or does not receive the revenue
  - <u>Public good nature of information</u>
    - **Free-riding problem** – the receipt, by a firm or individual, of a benefit from an externality at little or no cost.
      - i.e. if they can receive the info for free, they won't or they'll just use the information paid by someone else
  - It's <u>difficult for a firm to charge for producing accounting information</u>. Furthermore, the firm <u>can't generate revenue or benefit</u> from all its information production. Therefore, firms produce less information than socially desirable
- **Market forces** may not be completely effective
  - <u>Adverse selection problem</u>

        - Insider trading – info withheld from market for insiders' private benefit; ESOs have "pump and dump" problem
    - Moral hazard problem
        - EM to disguise shirking – EM to inflate earnings via accruals etc. … "accruals anomaly" (Sloan), markets can't distinguish between cash earnings and accruals earnings
    - Lack of unanimity/agreement between mgrs. and shareholders
        - S/H demand more info than what managers want to supply
            - FV accounting, values determined by markets, risk of poor pricing/measurement that'll affect managers' performance therefore, compensation risk increases – less efficient contracting with mgr.
            - FV based earnings more volatile, increase likelihood of costly debt covenant violation – less efficient contracting
- **Disclosure principle does not always work if there is a cost of disclosure**
    - E.g. if cost of disclosure is propriety cost, investors cannot penalize firm for non-disclosure since they don't know whether the information is withheld because it is (i) Bad News or (ii) Good News. If it is good news, it may not be sufficiently *Good News* enough to warrant the incurrence of the cost of disclosure – may cause firm to lose its competitiveness.

Do we need regulation?

- Firm should produce information to the point where its marginal social benefit = its marginal social cost. And since private market forces unlikely to produce this result, regulation is needed.

Voluntary disclosure allows signaling to happen.

Costs of regulation

- Direct cost of **administration and compliance**
- Indirect costs of uniform standards which **reduces firm's ability to signal**
- Indirect costs of litigation due to legislation and **disincentive to provide information**
- Imposing **homogenous accounting on heterogeneous transactions**
    - Homogenous: uniform in character or content
    - Heterogeneous: distinctly nonuniform in character or content
- Governments are not neutral

Optimal amount of **disclosure** is where marginal benefit = marginal cost
Optimal amount of **regulation** is where marginal benefit = marginal cost

Conclusion

- Lots of reasons why firms want to produce information
- Managers have private incentives to disclose – contractual and market-based
- Managers signal firm specific inside information about their differential quality (what makes them better than other firms)
- But there are also many sources of market failure
- Free market forces may not be effective due to externalities, free riders and agency problem
- Regulation of information production is not entirely the solution – still debatable whether how much regulation is needed (socially optimal level)
- Regulation has a cost and a benefit, therefore, optimal level of regulation would be where benefit = cost.