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Financial Accounting Theory and Research

Financial accounting emerged in response to managers’ need to communicate to owners whether the latter’s capital has been preserved intact and whether investments have yielded income, and, if so, how much. Accounting is a tool by which management fulfils its stewardship function toward stockholders: management accounts for how it safeguards and manages the owners’ resources. Seen from this perspective, accounting is a monitoring mechanism either demanded by stockholders or volunteered by management to minimize the diversion of resources to activities that do not serve the owners’ purpose. Over time, however, accounting has evolved to play an additional role that transcends this stewardship function: providing information for consumption and investment decisions. Thus, stockholders require reporting not only to obtain an agreed-upon measure of performance, but also to obtain information on the basis of which they can make future decisions. The latter can also be referred to as “signalling.”

The Nature of Financial Accounting Theory and Its Environment

Unlike finance, the discipline of accounting currently lacks anything approximating a theoretical underpinning. An accounting theory must accomplish two objectives: (1) describing and explaining accounting practices as an equilibrium phenomenon within a market with diverse constituencies; and (2) paving the way for the normative improvement upon what currently exists.

The fact that constituencies (investors, financial statement preparers, financial analysts, auditors, investment bankers, the government, and others) exert pressure on accounting rule-making bodies (e.g., the Financial Accounting Standards Board [FASB] in the USA) to establish accounting standards that would further their own self-interest implies that a formulation of an accounting theory is not feasible. However, it is possible to examine the role of different constituencies that are involved in the accounting process and the conflicts of interest among them so as to gain insights about what accounting statements and disclosures we might expect to emerge.

The role of accounting rule-making bodies (such as the FASB) in an environment of conflicting interests also should be to gain an understanding of what corporations would voluntarily disclose truthfully. For example, would self-interested corporate managers have incentives either to withhold information that is important for resource allocation or to disclose misleading information? After all, managers possess private information gained from their intimate involvement in operational activities, and they can signal expectations about future cash flows contingent on their own actions when given incentives to do so. Given the conflicts between owners and managers (and divergent preferences), managers do have an incentive to misrepresent. In fact, there is evidence that managers "manage" earnings by using the flexibility they are accorded under GAAP or even by violating GAAP and delaying the disclosure of
negative information until the auditor, the SEC, investigative reporters, or plaintiffs' attorneys flush the news. Furthermore, they may withhold information or provide misleading disclosures. The recent accounting scandals involving Enron, WorldCom, and the like attest to the gravity of this hazard.

This pernicious impulse to misrepresent is made all the more powerful by the dominance of short-horizon shareholders who prefer that the managers (their agents) inflate income and forecasts, and hence share prices, enabling them to make speculative short-run profits (see Ronen and Yaari, 2002). Of course, managers frequently make up a portion of this class of shareholders. It has been shown that there does not exist an equilibrium whereby all companies voluntarily and truthfully disclose private information, as some companies are dominated by short-horizon investors who induce financial statements that inflate investors' perceptions of the firms' value. Thus, companies dominated by short-horizon investors are over-priced, and companies dominated by long-horizon investors are under-priced. Another implication is that prices never fully reflect the implications of voluntary disclosures even when these are truthful. Viewed from this perspective, the culprit behind a misleading financial statement is not necessarily the CEO or CFO but rather shareholders who crave a short-term boost in stock prices. The desire to build reputation in the market for corporate executives will not deter dissembling. Indeed, executives who misrepresent will find that they are enhancing their reputation among the large and expanding market segment of short-horizon investors.

In the USA, class action suits brought under the Securities and Exchange Act of 1934 are designed to create disincentives not to report truthfully, but they fail to accomplish this objective under the existing legal system. In fact, they may deter managers from disclosing relevant information that they have no duty to disclose under present rules. Under these circumstances, the optimal amount of misrepresentation induced by the intricate web of existing incentives and disincentives (compensation schemes, legal liability, and ethical rules of conduct) is above zero.

Primary gatekeepers such as auditors will not alleviate the hazards of misrepresentations under the existing social arrangements (witness Enron and the demise of Arthur Andersen). Because they are compensated by the clients they audit, auditors are subject to an inherent conflict of interest. Lucrative fees and the promise of indefinite re-engagements offer strong temptations to do management's bidding. A cure recently suggested calls for the insurance of financial statements against losses caused by omissions and misrepresentations for the benefit of shareholders whereby the insurance carrier would hire the auditors, eliminating the conflict of interest (see Ronen 2002). Insurance coverage and the premium would be disclosed publicly to serve as signals for the underlying quality of the financial statements.

The role of the FASB and other regulatory bodies, were they to identify the existing deficiencies in disclosure due to the lack of sufficient incentives, would then be to suggest incentive schemes for the generation and provision of useful information.

*Accounting Standards, Uniformity versus Flexibility, and Principals versus Rules*
Should management be afforded flexibility among alternative treatments that would fit the different circumstances in ways that satisfy accounting objectives? Increasing the uniformity of accounting standards could reduce audit (monitoring) costs and the ambiguity of the resulting signal. Reducing the ambiguity of the signal should increase the reliability of the resulting inferences.

On the other hand, confining generally accepted accounting principles eliminate the flexibility that managers can use to convey their expectations of the firm's prospects if they have the incentives to do so. This reduction in the ability to signal counteracts the reduction in monitoring costs produced by enforcing uniform standards. Thus, there is an optimal amount of uniformity of accounting standards that balances the costs of limiting management flexibility and signalling against the benefits inherent in the reduction of monitoring costs due to uniformity.

In light of the recent accounting scandals, the SEC, FASB, and others have been clamouring for movement away from detailed rules toward more general principles. Yet it is not clear what these regulators mean by "principles." If principles are supposed to be general guidelines akin to a conceptual framework, this would take us back to the pre-FASB era, when far fewer rules were binding. Yet that era witnessed a plethora of accounting scandals. It is reasonable to expect that unless managers' and auditors' incentives are properly aligned with those of long-horizon shareholders, the elimination of rules will only serve to exacerbate the problem of misrepresentation.

The Descriptive Role of Accounting

The informational role of accounting has both descriptive and normative implications. A descriptive finding that accounting information is used in decision-making by market transactors is a necessary, but not a sufficient, condition for the claim that the manifested effects should guide the selection among accounting alternatives.

A large body of empirical evidence suggests that accounting information is used but that it explains only a small proportion of the variations in stock returns. Yet the suggestion that earnings should be the sole criteria by which to judge the use of accounting reports is fraught with hazard. The problem of factors jointly influencing returns is a severe one and cannot be addressed adequately by empirical studies. Earnings are but one, albeit important, output of the financial accounting process. Producing earnings, however, requires generating contemporaneously available accounting information other than earnings that also contributes to the explanation of returns. The cumulative effects of balance sheet items as well as other accounting variables can be viewed as the informational outputs of the “earnings” generating process. An emphasis on this process as an informative source also implies that the earnings generating process is designed more to reveal a firm's economic structure than simply to release each period's data. That is, the process may be viewed as building an archival history to facilitate predictions of how a company will respond to new external developments.

Inference of use, however, does not imply usefulness. Use does not entail the desirability of the resulting resource allocation and the social utility derived from risk-sharing induced by the accounting information so “used.” Securities' prices would reflect the net benefits of accounting information if such information were sold at a
competitive market price. Accounting information, however, does not constitute a “private” good in the sense that it is exchanged in the market place. It cannot be sold to consumers (users of accounting information) because of the difficulty of guaranteeing exclusive access to the information if it were sold. As a result, no market price exists that can be used to assess the net benefits of different accounting alternatives.

Interpretation of the Evidence

Aside from the impossibility of inferring desirability, assessing the “effects” of accounting and auditing methods is fraught with hazards. An observed effect (e.g., an association of an accounting number, change in method, or regulation with a price movement) need not be attributable to the accounting “event.” Consider the two cases: (1) when an association is observed, and (2) when no association is observed.

The first case is consistent with one or more of the following:

(a) The observed price change is induced incrementally by the accounting event, reflecting a change in the fundamental value of the firm that would not have occurred in the absence of the accounting event.
(b) Publicly known non-accounting events would have induced the same price change in the absence of the accounting manifestation.
(c) The accounting manifestation was not a cash-flow event, but it induced a price change because it was perceived as a credible signal of management's expectations about the firm’s future prospects.
(d) Without the accounting information, traders would have acquired substitute private information that would have resulted in similar (or different) equilibrium price changes. That is, the observed price changes need not reflect the incremental impact of the accounting event.
(e) Managers misrepresent, and traders rely on the misrepresentation as if they were true, in light of high costs of private information acquisition or the promise of recovery under legal statutes and the case law, so that the price change coincident with the accounting misrepresentation is a distorted reflection of changes in the fundamental value of the firm.
(f) The price change associated with the accounting event, by itself, does not fully reflect the information content implied in the event. Other measures must be incorporated, some observable (such as trading volume) and some perhaps not easily observable (the dispersion of traders' beliefs).
(g) The price change associated with the accounting event does not fully capture the information content of the publicly announced accounting event because in a noisy rational expectations capital market equilibrium prices do not fully reflect publicly available information; i.e., the capital market is not semi-strong efficient. (See Dontoh et al., 1994).

Thus, the observation of an association between the two does not tell us much about the “use” of accounting information.

Similarly, in the second case, the observation of “no effect” need not imply that accounting information is not used:
(1) First, even if there is no observed effect on market prices, the accounting event may have an effect on utility transfers among individuals, as manifested in trading activity—clearly a relevant factor if wealth distribution is considered important.

(2) Second, the effect of an accounting manifestation may become visible after the accounting report is issued. Thus, a disclosure that management took a particular action (or a financial statement manifestation of the action) may have little or no effect at the time of disclosure. Later, however, an unexpected event that significantly alters cash flow expectations (given that management had taken the prior action) would affect stock prices.

One cannot argue that the observed effect on the security prices is solely attributable to the information about the event. Rather, the effect is a joint result of (1) that particular event and (2) the action taken by management that had previously been disclosed in the accounting reports. Under other circumstances, the disclosure of an action may have an “effect” that is conditional on information that becomes available only later. In this situation, it is wrong to claim that the disclosure of the action in the annual report had no effect. In other words, security market prices cannot be used definitively to assess whether accounting information has an effect on the market equilibrium.

Thus, event studies that focus on the association between market returns and accounting numbers do not shed much light on whether accounting numbers are used. Even if they did, we would still be in the dark about the usefulness of any accounting numbers whatsoever. Existing empirical evidence, as well as the evidence likely to be produced by future empirical studies, provides little, if any, guidance regarding how to structure the accounting model, how to report, and how to formulate the objective, scope, or procedures of accounting and auditing.

**Studies of the Value Relevance of Accounting Information**

Many studies have employed a "value-relevance" methodology (finding associations between prices or measures derived wherefrom and accounting numbers based on alternative treatments) in an attempt to derive implications for formulating accounting policy (for a representative list of such papers, see Table 1 in Holthausen and Watts, 2000; specific examples are Dhaliwal, Subramaniam, and Trezevan, 1994, and Aboody, 1996). In these studies, prices are (or are assumed to be) the best available reflection of fundamental value; hence, accounting treatments that generate numbers more closely associated with prices (or measures derived from prices) are superior to accounting treatments that generate numbers less closely associated with prices (or measures derived from prices). This logic is problematic for a variety of reasons:

1. One cannot assess the usefulness or desirability of a given accounting treatment solely by means of association with prices or measures derived from prices (such as returns, abnormal returns, etc.).

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1 This section is based on Ronen, 2001.

2 The association of accounting numbers generated by a given accounting treatment may provide some information, albeit not such as would reveal whether the treatment is useful or desirable. For example, a higher association between price and accounting information with capitalized R&D and between price and accounting information with expensed R&D may imply that price behaves as if cumulative R&D expenditures are considered as associated with future cash flows. Yet this observation, by itself,
can only be assessed relative to an alternative accounting treatment, B. However, comparing an association between accounting numbers generated by A and price-based measures and a similar association of accounting numbers generated by B cannot lead to valid inferences regarding the superiority of A or B. For example, suppose that A represents an accounting treatment that expenses R&D, whereas under B R&D are capitalized and amortized. Suppose we find that the latter treatment yields numbers more closely associated with prices (with proper controls). Yet the price with respect to which the association of capitalized and amortized R&D is measured is the price associated with the current system of expensing R&D. The proper comparison would be between the pair (expensing R&D, current prices) and the pair (capitalizing R&D, prices associated with capitalizing—different from the prices associated with expensing). Current value-relevance studies cannot accomplish this task.

2. It is now well known that prices contain not only information about fundamental values but also noise caused by trades that are not based on fundamental information (see, e.g., Grossman, 1995, and Krause and Smith, 1989). Liquidity trading, noise trading, and capital movements from and into other sectors of the economy will cause prices to diverge from fundamental values at different times. Thus, there is no a priori reason to expect that prices reflect fundamental values better than accounting numbers to begin with. In fact, as Dontoh et al. (2001) show, prices reflect fundamental values more poorly than accounting numbers do.

3. The argument is circular. If accounting provides inputs used by market traders to decide on their demand for and supply of securities, and if markets are semi-strong efficient under the maintained hypothesis, the prices by definition impound the information content of the accounting numbers. Now, suppose it is assumed that prices contain no information other than the accounting information (no non-accounting publicly available information, no private information or beliefs formed on the basis of non-accounting information.) In this case, prices cannot be viewed as a useful benchmark against which to evaluate accounting information: they will reflect no more than the accounting information itself plus noise possibly injected into them by liquidity or noise trading.

Therefore, if association is to furnish the criterion by which to assess usefulness of accounting numbers, prices must reflect fundamental values better than accounting information because of non-accounting information (either publicly available from other sources or privately acquired by market traders) that is reflected in prices but not in accounting numbers. In this case, testing the association amounts to testing whether the accounting numbers reflect non-accounting information otherwise impounded in prices. If, however, prices were indeed a better reflection of fundamental value than accounting numbers because they contained the non-accounting information, there would be no demand for assessing the “value relevance” of accounting numbers in the first place.

Finally, consider, in the interest of fairness, the following argument in favour of association tests. Non-accounting information imbedded in prices may not be
correlated with accounting information, but it helps in interpreting and assessing the reliability of the accounting information; thus, high association may imply a high degree of reliability and therefore usefulness. To evaluate this argument, one needs to reflect on how non-accounting information can perform this role. Since it does not duplicate the substantive content, non-accounting information is useful only in conveying an understanding of the environment in which the accounting information is generated. This environment includes managerial integrity and honesty, incentives to manage or manipulate earnings, managerial skill in applying internal controls and in safeguarding the integrity of the information system, etc. Thus, under the best of circumstances, degrees of association between price and accounting information may shed some light on managerial incentives or skills, or how the managers may distort the application of accounting policy. Degrees of association, however, do not imply the desirability of particular accounting policies or treatments.

Conclusion

We are left with what may be the only promising path toward a financial accounting theory: normative research (including empirical or experimental tests of the assumptions underlying the normative analysis). Of course, this should not exclude consideration of the social welfare implications of GAAP alternatives. To the extent that such implications are best determined in the political process, the aim of research should be to provide valuable inputs to the political debate. This research should certainly allow for well-reasoned, well-thought-out hypotheses regarding which accounting models would best serve society's needs.

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