SUBMISSION BY THE
NEW ZEALAND BUSINESS ROUNDTABLE

Financial Reporting Bill

FEBRUARY 1992

FINANCIAL REPORTING BILL

1.0 INTRODUCTION

1.1 This submission is made on behalf of the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies which reflect overall New Zealand interests.

1.2 The NZBR's interest in the Financial Reporting Bill (the Bill) stems from its desire to promote policies which will enhance the efficiency of New Zealand's equity and debt markets. These markets play a key role in allocating resources among alternative uses and they facilitate competition for the control of large publicly-held companies. They are critical to the achievement of a sustained increase in the real rate of economic growth and hence a rise in living standards. Thus the regulation of financial markets, including mandatory reporting requirements, is a significant public policy issue.

1.3 The thrust of our submission is that a compelling case for requiring public issuers to comply with generally accepted accounting practice, and for modifying the longstanding test that the accounts of certain entities should provide a true and fair view, has not been established. We are sceptical that a valid case could be made for the proposals contained in the Bill. In particular, the economic costs of the proposals have not been properly analysed.

1.4 The main analyses which preceded the Bill, the *Report of the Ministerial Committee of Enquiry into the Sharemarket* (the Russell Report) and the Securities Commission report *Capital Structure and Financial Reporting in New Zealand*, were woefully inadequate from a public policy viewpoint, and would not withstand scrutiny by recognised international experts in the area. The Ministerial Working Group on securities law reform, which analysed the issue in a more robust framework, was opposed to the introduction of mandatory accounting standards. It concluded that the Companies Bill should give guidance as to what is true and fair by deeming compliance with generally accepted accounting practice (GAAP) to be prima facie evidence that the financial statements present a true and fair view. Any departure from GAAP would have to be disclosed and explained. This view is significantly different from that reflected in the Bill.

1.5 We believe that in responding to loosely defined concerns about some accounting practices, the ethical standards of some managements and pressures on auditors, the government runs the risk of impairing the efficiency of debt and equity markets. For the reasons discussed in section 5.0 of this submission, the proposals may also increase, rather than reduce, uncertainty in those markets, thereby hindering an emerging rise in business confidence. This contrasts with the carefully constructed plan to introduce new companies legislation which would give New Zealand a competitive advantage in the international market place. Furthermore, harmonisation of accounting practice and company and securities law with that of other jurisdictions is not an end in itself. Such policies need to be evaluated against the standard efficiency and equity criteria.

1.6 Although it is frequently claimed that there is widespread non-compliance with existing accounting standards, we endorse the following comment of the Ministerial Working Group on securities law reform:

> "Despite claims of frequent non-compliance with financial reporting and disclosure requirements there is in fact no systematic evidence that New Zealand has been characterised by a high frequency of such non-compliance either in absolute terms or relative to other countries."

Furthermore, there is no evidence that New Zealand's accounting standards are inferior to those of comparable countries.

1.7 In our view, the proposals contained in the Bill should be held in abeyance until a rigorous analysis of their costs and benefits has been undertaken. This would need to address fully the range of points briefly discussed in this submission. This view is consistent with the view which we expressed in commenting on the Companies Bill.

2.0 THE GOVERNMENT'S PROPOSALS

2.1 The key proposals set out in the Bill are as follows:

- public issuers would be required to prepare financial statements (or group financial statements) which comply with generally accepted accounting practice (GAAP). This would make the application of accounting standards mandatory for such issuers;

- the key current criterion that a firm's profit and loss statement and balance sheet (its accounts) provide a true and fair view would be modified. If financial statements (which are defined to be much wider than the accounts) prepared on the basis of GAAP do not give a true and fair view, there is an obligation on the directors (in the case of a company) to add supplementary information and explanations so that a true and fair view is presented. The accounts themselves would not, however, be amended;

- issuers would be required to prepare a cash flow statement annually in addition to the current requirement to prepare a profit and loss statement and a balance sheet;

- the auditor's report to members, which is mandatory, is to include an opinion on whether the accounts comply with GAAP. In addition, the cash flow statement is to be audited and "notes or documents relating to the balance sheet, statements, or accounts" are also to be taken into account in auditing the financial statements. This could extend the impact on annual reports of a mandatory audit beyond the profit and loss account, balance sheet and cash flow statement and notes thereon to other information and reports such as the directors' report;

- an accounting standards board is to be formed to approve accounting standards submitted to it;
- the requirement for issuers to prepare financial statements within a particular calendar year is to be tightened;
- significant penalties for not preparing and filing financial statements are provided.

2.2 For the purposes of the Bill, GAAP is defined so as to require compliance with applicable accounting standards and, in relation to matters for which no provision is made in such standards and that are not subject to any applicable rule of law, with accounting polices that are appropriate to the circumstances of the issuer and have authoritative support within the accounting profession. (It is unclear whether this is limited to the New Zealand accounting profession.)

2.3 An issuer is broadly defined to encompass entities which have issued securities to the public, including entities that have issued securities to the public prior to the implementation of the Bill. An issuer includes every person who has allotted securities for which a prospectus is required under the Securities Act or the Companies Act, and certain life insurance companies, overseas companies, unit trusts and registered banks (from a date to be determined), and every person who is a party to a listing agreement. Some issuers, such as the Crown and local authorities, are exempt from the requirements of the Bill. The proposal will therefore affect many entities. The financial reporting provisions applicable to companies and other organisations which are not issuers or are exempt will not change. There will be an incentive for firms which do not wish to comply with mandatory accounting standards to structure themselves in such a way that they are not deemed to be issuers (other than exempt issuers) for the purposes of the Bill.

2.4 The proposals give rise to two main issues which are the focus of the balance of our submission. These are:

- whether accounting standards should be mandatory; and
- whether the standard of a true and fair view should be modified as proposed.

3.0 SHOULD ACCOUNTING STANDARDS BE MADE MANDATORY?

3.1 A major responsibility of governments in a modern economy is to provide a clear definition of private property rights, such as the right to own land, including the rules under which such rights may be traded. These rules are designed to enable voluntary contracts to be enforced at an optimal cost. The role of the state in declaring fraud and theft to be crimes and in providing resources to investigate allegations of them and penalties for firms or individuals who transgress, for example, can be justified on this basis. The grounds for the government going beyond the rules within which private property rights are generally traded and setting specific rules related to trade in particular rights, such as the rights pertaining to an ownership or creditor stake

in a company (or other organisation), should be evaluated on the basis of the benefits and costs of the specific proposal.

3.2 A contemporary view postulates that a firm is likely to be formed where the transactions cost of direct contracting between the suppliers of inputs, such as labour and capital, and the final consumer is large. In these circumstances, the firm will internalise the market in organising labour, capital and other resources to produce and distribute goods and services. While this process provides the benefits of specialisation and lowers the total cost of production, distribution and transacting relative to other possible forms of organisation, it is not costless.

3.3 One major cost flows from the fact that for many firms the interests of the owners (equity holders) are different from those of the managers, including (in the case of a company) directors. Moreover, where the firm is partly financed by debt (or financed by separate classes of equity) there is a conflict of interest between the equity and the debt holders (or classes of equity holders). There would, for example, be no easier way for a company to escape the burden of its debt than to pay out all of its assets in the form of a dividend, and leave the creditors with an empty shell. This divergence of interests arises from the fact that owners and debt holders can be expected to maximise their utility. It give rises to agency problems.

3.4 An analysis of the agency problems which arise between equity holders and management and between debt and equity holders is central to the question of whether accounting standards should be made mandatory because the provision of financial information is one mechanism which is available to control agency costs. The accounting concept of stewardship incorporates a comparable approach (Watts and Zimmerman (1986)). The Ministerial Working Group on securities law reform adopted a similar framework for the purposes of evaluating financial reporting.

3.5 Principals, such as equity holders and debt holders - in the case of the conflict between owners and managers and debt and equity holders respectively - know that the agent's interests are not the same as theirs. They will therefore provide incentives for the agent and monitor the agent's behaviour with a view to minimising the extent of any divergence in interests. In addition, it will pay the agent in some circumstances to commit resources (bonding costs) to guarantee not to take certain actions which would harm the principal or to compensate the principal if such actions are taken. The agent can gain by agreeing to monitoring and bonding arrangements because they reduce the principal's costs. Thus principals and agents have incentives to agree optimal bonding and monitoring arrangements.

3.6 When transacting is costly, optimal incentive, monitoring and bonding arrangements will not eliminate agency costs. The residual loss reflects the costs which it is not optimal to avoid i.e. some divergence between the actions of the agent and the interests of the principal is accepted as a fact of life. The size of the residual loss can be expected to be governed by the equating of the marginal benefit of monitoring and bonding costs and the marginal saving in the residual loss. An investor, in assessing the expected return from shares in

the firm, can be expected to take the likely size of the residual loss into account. Similarly, the interest rate at which the marginal debt holder is prepared to invest reflects the expected divergence of interest with management.

3.7 Within the above framework and in an otherwise unregulated market, it could be expected that management would voluntarily supply financial information to equity and debt holders provided the costs involved do not outweigh the benefit of lower agency costs. The amount, timeliness and form of information supplied would not be the same for all firms because the level of agency costs could be expected to differ from firm to firm.

3.8 The voluntary provision of information prior to the regulation of financial reporting and the analysis of borrowing agreements generally supports this analysis. Manne (1974) reports research by Benston which showed that prior to 1934 more than one half of United States firms reported information of the class which was subsequently required to be produced compulsorily. Moreover, Benston found that 38 percent of the companies listed on the New York Stock Exchange which he examined did not disclose the level of sales prior to the introduction of compulsory disclosure of sales information. This was the most significant item which had not previously been disclosed by most companies. Following the introduction of the disclosure requirement, Benston found that there was no change in the relative value of the shares of previously non-disclosing firms compared to those that had voluntarily disclosed sales. He suggested that the disclosure requirement had been of no value to shareholders. Whittred (1987) has shown that consolidated financial statements were presented in Australia prior to regulation of accounting disclosure where the financing and activities of parent companies and their subsidiaries were closely linked. In these circumstances, such statements were likely to be beneficial to shareholders and debt holders. Smith and Warner (1979) analysed recommended bond covenants under certain standard documentation. They argued that the covenants could be explained in the context of agency costs. Their comment on why such covenants did not prescribe the method of accounting is insightful:

> "It is expensive to specify the accounting procedure by contract and, if the specified procedure differs from GAAP, it is expensive to prepare an additional set of accounting statements for the bondholders. Such detailed procedures can be a more costly mechanism for the bondholders to protect themselves against 'creative accounting' than by requiring external auditing and reflecting any residual risk of accounting manipulations in the price paid for the bonds."

3.9 Under the Bill the accounting standards board would assume the task of defining accounting methods, which borrowers and lenders often avoid or only partially prescribe, not just for a single entity but for all issuers.

3.10 The conclusion which we draw is that private markets can be expected to provide information to shareholders and debt holders where it is economic to do so. This view has been supported by recent empirical research which has increasingly found evidence that voluntary information markets worked well

prior to the 1930s when substantial regulation on financial reporting was introduced in many countries.

3.11 In order to justify mandatory compliance with accounting standards, it is necessary firstly to show some impediment in the market **and** secondly that the benefits of correcting it justify the costs involved. Some of the arguments which have been raised in support of mandatory standards are commented on below. We remain sceptical that any of the arguments stand up to close scrutiny.

4.0 ARGUMENTS WHICH HAVE BEEN ADVANCED FOR COMPULSORY ACCOUNTING STANDARDS

Financial Information is a Public Good

4.1 One argument is that financial information has the characteristics of public goods. These are goods for which it is both excessively costly to exclude non-payers from enjoying their benefits and which it is inappropriate to charge for because the marginal cost of supply is zero. The alleged difficulty in producing information arises from the first property. (As far as we are aware, no one seriously argues that the marginal cost of producing financial statements is zero.) If producers are unable to exclude non-payers from the benefit of information, the level of its production is likely to be less than otherwise.

4.2 This feature of financial information is, however, insufficient to support mandatory accounting standards for the following reasons:

- the existence of a large securities analysis industry suggests that there are private benefits from discovering new information about firms' financial state;

- if an investor discovers information and uses it, resulting in a change in security prices, then the value of that information is appropriated. In this sense financial information is a private and not a public good;

- many goods contain some elements of the properties of public goods because it is not costless to exclude non-payers from benefiting from their consumption. Private markets, however, have ways of addressing the problem. It has been suggested, for example, that the difficulty in selling exclusive rights to information on the credit risk of firms and individuals helps to explain the existence of financial intermediaries which bundle this service together with the provision of loans. Moody's and Standard and Poor's solve the problem by requiring the firm which they rate to pay for their services. Furthermore, the problem of excluding non-payers is not unique to public goods. It arises in respect of all goods and accounts for numerous efforts to protect property rights;

- it is not obvious that the optimal solution to the problem is to mandate accounting standards.

Protection of Creditors and Investors

4.3 It is sometimes argued that external parties, which have little bargaining power, need access to information in order to be able to assess the merits of their equity or debt investments. This argument is sometimes combined with the idea that investors are naive.

4.4 The foregoing discussion suggested that in an unregulated market, financial information will be supplied up to the point that it is cost effective to do so. It should also be noted that the distinction between naive investors and other investors is an emotive one. The distinguishing economic characteristic is that the naive investor has not invested in the skills required to analyse financial data to search for new information, perhaps because he or she lacks the capacity to do so, and therefore does not benefit from the rewards from such investment. A naive investor could, however, buy the required information either directly or by placing his or her funds with a professional investor (Leftwich (1980)). Furthermore, to the extent that new information is rapidly compounded into security prices, naive investors benefit from the immediate impact of new information on the value of their security. Lastly, naive investors are unlikely to read financial statements.

Lack of Comparability

4.5 One of the most commonly advanced arguments for mandatory standards is that the diversity of accounting treatment makes comparisons among companies difficult. A commonly cited calculation suggested that when a subset of possible events is considered, management could choose from among 30 million alternative packages of accounting method (see Leftwich (1980)). The desire for greater uniformity of accounting methods was a major motivation for the promulgation of accounting standards by the accounting profession in the United States (Story (1964)). It is argued that by judicious shopping, management can exercise excessive choice over the accounting method which it desires, with detrimental effects on shareholders and creditors.

4.6 One major reason for the wide choice of accounting methods is that accounting practice is not based on a single coherent theory. Thus different accounting methods are not easily evaluated against a commonly held set of principles. Presumably for this and other reasons, prominent members of the accountancy profession have served on boards which have chosen not to comply with accounting standards.

4.7 The absence of an agreed conceptual framework probably means that uniformity of accounting standards is unobtainable in the absence of government intervention. Should the government intervene, it (or its agency - the accounting standards board) must decide among the available treatments. The question of accounting choice is merely moved from the private to the public market. The incentives facing public bodies are considerably weaker than those facing private sector agents. Moreover, Smith and Warner suggest that because it is costly to prescribe accounting standards, lenders and

borrowers have often not done so. This raises the issue of whether it is cost effective for external agencies to assume this role.

4.8 There is, however, a more fundamental question. This is whether it is desirable to seek uniformity via regulation. Leftwich (1980) notes that it is not necessarily in the interests of shareholders to constrain management to use the same accounting rules regardless of the circumstances facing the firm. The management's choice of accounting method can affect the firm's cash flow via its effect on negotiations relating to input and output prices. As noted below, uniformity of accounting treatment reduces the scope for firms to compete by signalling their superior accounting practices and thereby acts as a barrier to competition. It also subsidises the securities industry which is a major user of financial statements.

4.9 Another argument which substantially undermines the case for mandatory accounting standards is that portfolio theory shows that investors, by holding a fully diversified portfolio of assets, can eliminate entirely the risks which pertain to an individual firm. In this case, it seems that the lack of comparability of financial statements is of little consequence. Small investors can obtain the benefits of a diversified portfolio by investing in an appropriately constructed pooled fund.

4.10 Finally, it is not sufficient merely to show that firm XYZ accounted for a particular transaction in a questionable manner. It is necessary to show that the benefits of the proposed regulation outweigh the costs involved. We now turn to the costs of mandatory accounting standards.

5.0 THE COSTS OF MANDATORY STANDARDS

5.1 The imposition of mandatory standards is not a costless exercise. The costs involved include the following, not all of which are readily apparent:

- the direct costs of preparing financial statements in a form different from that which would otherwise be used. These costs are likely to be low in most cases but could be expected to be more significant for small issuers and for firms which are required to comply with the regulatory requirements of other countries e.g. the United States Securities and Exchange Commission (SEC);

- the indirect cost of the time involved in preparing submissions to the accounting standards board on the effect and impact of proposed standards. This is likely to consume significant resources because once standards are mandatory, firms will in most cases be forced to fall into line or receive a qualified audit report. They can be expected to devote more resources to standard setting than has been the case to date. Moreover, as explained below, mandatory accounting standards can be expected to have significant real economic effects;

- accounting practices can affect management and investor decisions and thereby have real economic effects. For example, a United States accounting requirement which resulted in the non-symmetric treatment

of gains and losses from foreign exchange translations induced firms to undertake unnecessary hedging transactions;

- mandatory standards, as with comparable regulations, reduce competition because they impose the same methods of accounting on all firms regardless of their size or mode of operation. Put another way, firms which wish to distinguish themselves in the market by adopting more conservative accounting treatments than their competitors will be unable to do so. These factors may discourage new entrants, thereby diminishing the dynamism of the economy, and disadvantage the most sound firms;

- the proposal to require all financial statements of issuers to comply with standards will discourage the inclusion of alternative information in financial accounts. Standard setting bodies typically reflect innovations in accounting practice with a lag of 2-3 years. For example, for a considerable period the SEC prohibited the disclosure of profit projections. Contentious accounting treatments, like the inclusion in the accounts of values for intangible items such as mastheads, are likely be be excluded from the accounts because of the difficulty of valuing them, despite their economic reality. While disclosure of supplementary information may at first sight appear to lessen this impact, as noted below it is the accounts themselves which are currently important in determining whether various loan covenants (and similar contractual provisions) have been complied with;

- to the extent that mandatory accounting standards impose costs on public issuers, there may be a shift toward higher cost private placements and a reduction in the liquidity of such securities. Research has shown that there was a shift toward private placements following the establishment of the SEC. Furthermore, this research showed that the degree of shift was directly proportional to the degree to which the SEC regulations caused the provision of misinformation;

- the 'solution' of providing supplementary information may create further complications. Consider a situation where the directors (who are responsible for the accounts) and the firm's auditors conclude that the prescribed mandatory standards do not meet the true and fair test. (This is not an unlikely eventuality. If it were, there would be no grounds for modifying the true and fair test.) Assume that both agree, consistent with the scheme of the Bill, that the situation should be dealt with by the provision of supplementary information. Also assume that the calculation of the firm's existing debt covenants is computed on the basis of the firm's audited balance sheet and income statement, as is normal. In this case, the calculation of whether the firm was within its borrowing limits could show a different result from that which would apply if the accounts had shown a true and fair view. There can, however, be no presumption that in such cases that situation will produce a result which furthers the borrower's position. This situation could occur if the accounting standards board were to follow United States standards which require finance subsidiaries of non-financial entities to be

consolidated. There is also an incentive to follow the standards and to provide supplementary information, thereby weakening the effect of standards. To the extent that this occurs, the effect of the Bill would be to modify contractual arrangements which have been entered into by lenders and borrowers;

- to the extent that standards change the basis of accounting from that currently in use, they could be expected to have real effects. Firms which are close to their existing borrowing limits, which were perhaps set in the knowledge of the existing method of accounting, may find themselves unable to borrow additional money. In an extreme case, this could result in the failure of the issuer. It may require the renegotiation of borrowing agreements;

- by attempting to protect risk averse investors, they discriminate against risk neutral and high risk investors. They impose on all firms the obligation to expend resources on activities that are not valued by risk neutral and high risk investors. There are no valid public policy grounds for favouring risk averse individuals and firms over others. Moreover, peoples' willingness to bear risk does not fit into neat categories but covers a wide spectrum from those who take substantial risks to those who are extremely cautious;

- studies have shown that changes in accounting methods (such as the treatment of depreciation or stock valuation) generally have no discernible effect on share prices. This suggests that so-called 'creative' accounting does not fool investors and raises doubts about the benefits to be derived from mandatory standards;

- the evolving nature of mandatory accounting standards will add a new element of uncertainty to the market for securities;

- mandatory standards subsidise the business of securities analysts and related industries by reducing the effort required to evaluate different entities. This is one reason why such industries can be expected to support mandatory standards;

- the costs of developing, publishing and enforcing accounting standards will not be negligible;

- the accounting standards board, like many government agencies, will face weak incentives. The costs of its actions will fall on other parties. There are few objective criteria for judging its performance.

5.2 The foregoing costs taken together cannot be assumed to be trivial, yet it appears that no real effort has been made to analyse them and to weigh them against the benefits which compulsory standards are claimed to achieve. In our judgment the uncertain benefits of mandatory accounting standards have not been shown to outweigh the costs involved. For that reason, we are of the opinion that the proposal should be held in abeyance until the matter is subject to a thorough review.

6.0 SHOULD THE TRUE AND FAIR TEST BE MODIFIED?

6.1 The apparent effect of modifying the true and fair test is to signal a reduction in the element of judgment involved in the preparation of financial statements and to signal a shift in emphasis toward the form of financial statements (compliance with accounting standards) rather than their substance.

6.2 According to the Securities Commission the true and fair test dates back to 1844. Its criticism was that there may be more than one true and fair view. A related criticism which has been advanced is that the courts have difficulty in deciding whether accounts present a true and fair view because expert accounting witnesses appear for both sides.

6.3 Although there have been few judicial decisions on cases involving the test and accounting standards, we understand that the courts do not generally regard compliance with accounting standards as sufficient to satisfy the true and fair test. Accounting standards have, however, been viewed as indicative of current practice.

6.4 Both the Law Commission and the Securities Commission concluded that the true and fair test should not be changed to a technical question of whether accounting standards had been complied with. The Ministerial Working Group on securities law reform concluded that the Companies Bill should give guidance as to what is true and fair by deeming compliance with GAAP to be prima facie evidence that the financial statements present a true and fair view. Their prime motivation was to encourage standardisation. They were, however, explicitly opposed to the proposal contained in the present Bill which requires financial statements to comply with mandatory accounting standards. We understand that the accounting profession supports the proposal to move towards a technical test and it would wish to see the Bill go further in this regard.

6.5 While an assessment of the legal intricacies of the test is beyond the scope of this submission, we are unconvinced that there is merit in moving in the direction proposed in the Bill. This view is supported by our concern that the merits of mandatory standards have not been properly evaluated. We are also sceptical that harmonisation with Australia is justified.

7.0 OTHER CONSIDERATIONS

7.1 It is simplistic to assume that the losses which occurred in the wake of the October 1987 crash would have been avoided by improved financial reporting. Investors in many countries with different accounting requirements suffered losses. More fundamental economic factors explain the crash. The key requirement to mitigate the risks of another crash is the pursuit of appropriate macroeconomic policies.

7.2 The relevant debate is not about the end goal of the need for integrity in New Zealand's financial markets in the interests of investor confidence. The NZBR is strongly committed to this goal. The issue is the most effective means to this end. We have consistently argued that a major problem in the securities area is

that remedies which are available in cases of wrongdoing have not been employed. The quality and performance of the relevant public sector agencies rather than the lack of law is of prime importance. There are grounds for allowing group actions (by, for example, shareholders) to be brought in appropriate circumstances. There is also a need to progress the carefully considered reform of company law along the lines recommended by the Law Commission.

7.3 The vulnerability of auditors to claims for damages from investors who suffer losses seems to be an underlying motivation for a number of public policy proposals, including those aimed at moving toward a technical test of the truth and fairness of financial statements. We are not aware that any fundamental examination has been undertaken of the regulatory issues which are involved. If this concern is a motivation for the accounting profession's support of the proposals contained in the Bill, we would suggest that the issue be confronted directly.

7.4 In the same context, there are grounds for reconsidering the requirement for firms to be subject to compulsory audit. The Law Commission and the Ministerial Working Group on securities law reform suggested that the current provision should be relaxed. This could also improve the relationship between auditors and firms by improving the incentives of both parties.

8.0 CONCLUSION

8.1 We submit that:

- the full costs and benefits of the proposal to make accounting standards mandatory have not been properly evaluated;
- it is unlikely that the benefits of the proposal contained in the Bill could be shown to outweigh the costs involved;
- the Bill should be held in abeyance until a proper study of the costs and benefits of the proposal has been undertaken;
- the true and fair test should remain unaltered until it is shown whether mandatory accounting standards are desirable on economic grounds.

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