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The Economics of Financial Reporting[i]

Focus Companies: Private and Public Companies.

Keywords: Information; Stewardship; Economics.

INTRODUCTION

Before getting into the details of providing auditing and assurance services, we need to pause and ask ourselves: why do companies provide financial information and why do companies have audits?

"WHY DO COMPANIES HAVE AUDITS?"

In this case, we discuss the role of disclosure and assurance (i.e., broader audit-like procedures) both historically and in today's heavily regulated environment. At a high level, we consider disclosure as serving an economic purpose and seek to understand the sources of demand for audit and assurance as an economic service that relates to disclosure.[ii]

FINANCIAL INFORMATION

In most modern settings, financial reporting (the process by which managers, or insiders, disclose, or reveal, internal information about their company's financial performance and financial position to interested external parties) is largely regulated. Regulation typically mandates, or set rules, that require specific companies to provide certain information to interested parties. We refer to this required disclosure as **mandatory disclosure**. Some firms also provide additional information to the market, beyond what is required by regulation, referred to as **voluntary disclosure**.

CONSEQUENCE | **COMPLEXITY** | **CONFLICTS OF INTEREST** | **REMOTENESS**

THERE ARE FOUR GENERAL ECONOMIC CONDITIONS that combine to create a demand for auditing and assurance services. (1) Consequence: Information, especially financial information, can have substantial economic consequences to a user of that information especially when making important economic decisions. (2) Complexity: Information can be complex and often expertise is required both for the preparation and the verification of information. (3) Conflicts of Interest: In many business environments there are conflicts of interest between an information preparer and the user of that information. This can result in the production of biased information. (4) Remoteness: The users of information are often unable to directly assess the quality of the information.

These four conditions provide the foundations for two theories that explain the demand for auditing and assurance services: stewardship of the firm and information quality released by the firm.

A BRIEF HISTORY LESSON

Auditing dates to at least as early as 500 to 300 BCE with auditing and assurance practices in Athens, where three state accountants verified state revenues and expenditures. In the United States, auditing was common practice even prior to the passage of the Securities Acts in 1933 and 1934, which mandated audits for public companies. In 1886, enough companies were engaging audit and assurance services that the professionals providing this service self-organized into what is now the American Institute of Certified Public Accountants (AICPA).

DESPITE THE MANDATORY NATURE OF AUDITS TODAY this significant historical evidence of voluntary audits is consistent with equity holders valuing audits. What features of the audit and assurance product are valued by equity holders, though?

IMPROVING STEWARDSHIP

Most public companies have an **agency relationship** between the managers and the providers of capital (such as lenders and equity investors). An agency relationship can be defined as a contract under which one or more providers of capital (often called **principals**) engage another person as their steward or manager (often called an **agent**) to perform some service (such as manage a company) on their behalf.[iii] In general, the operation of the entity requires delegating to the manager both significant decision-making authority and measurement and reporting of performance.

WHAT'S THE PROBLEM? Often the phrase **agency conflict** or **agency problem** is used to refer to the possible negative side-effects of the agency contract. Put simply, if we assume that the providers of capital and the managers they hire are both interested in maximizing their own wealth, and the providers of capital cannot perfectly monitor the manager's performance, then a self-interested manager may not always act in the best interests of the providers of capital.

WHY CAN'T THE PROVIDERS OF CAPITAL PERFECTLY MONITOR THE MANAGER? If the providers of capital had the ability to perfectly monitor the manager's performance, that is, how well the manager used the capital provided to them, then there would be no agency problem. But it isn't rational for a capital provider to delegate responsibility to a manager and then monitor every action that the manager undertakes. They would instead manage the company themselves (why incur the cost of hiring a manager if you oversee and correct all their actions).[iv] Partial monitoring of the manager can include the provision of periodic performance reports from the manager to the provider(s) of capital. With partial monitoring, the provider of capital faces a different problem, often called an **information asymmetry** problem: the manager has access to more information than the summaries of performance they give to the capital provider.

WHERE DOES THE AUDITOR FIT IN? As the providers of capital consider where to invest their capital, and when to liquidate their investment, they rely on the summary of the firm's performance that was measured and disclosed by the manager. Clearly, the provision of a performance measure alone doesn't always remove the agency problem between the providers of capital and managers because the manager can choose how to measure and report their performance. To the provider of capital, this means that the reported performance may not be an accurate reflection of the achieved performance, increasing the risk associated with their investment. The capital provider would then rationally either lower the amount of capital they provide to the manager (increasing the cost of raising capital from the manager's perspective) or they would lower the compensation paid to the manager (decreasing the reward from running the firm to the manager). Both actions are costly to the manager, so the manager will agree to a less costly option – to provide evidence that the reported performance has been measured carefully and is free of material errors or omissions. The product which provides this assurance to the capital provider is the independent audit.[v]

IMPROVING INFORMATION QUALITY

A second argument for the value of auditing is that investors demand audited financial statements because they improve the quality of the information derived from financial statements. Investors require timely, quality information about the financial prospects of an investment to make efficient purchasing decisions.

WHAT'S THE PROBLEM? Investors gain three main benefits from access to information: (1) the risk of their investment decreases as they receive higher quality information, (2) information improves decision-making, and (3) these features combined increase investors' expected wealth.

As investors will typically avoid taking on higher risk (in economics this is referred to as **risk-aversion**), one way to describe the value of auditing is that it improves an investor's ability to assess the risk of errors in the financial reports.

Keep in mind that auditing became mandatory when the SEC was established. The SEC followed the 1929 stock crash, which fueled one of the worst depressions in U.S. history. Mandating auditors' services was in part justified by claims that "adequate disclosures" would preclude future stock market crashes. At the time there was no evidence that inadequate disclosure practices caused the crash. You will notice, however, that in almost all major historical crashes, there is inevitably discussion of problems with accounting disclosures and auditing!

AN AUDITOR CAN IMPROVE PERFORMANCE MEASUREMENT directly by finding errors or indirectly by making company accountants more careful in preparing records in anticipation of an audit. For the modern audit, the integration of internal control testing within the audit product, often referred to as the **integrated audit**, allows for the audit to improve performance measurement by identifying deficiencies and weaknesses in internal company processes that can be improved. The processes, including "checks and balances" over the financial reporting process are referred to as a company's **internal controls**. These processes can be both operational processes (such as supply chain and inventory management systems), and processes within the financial reporting function (such as not having appropriate reconciliation processes for major accounts, or documentation about how an account that involves estimation is reviewed). A review of the internal controls of the company may reveal shortcomings in a company's control processes. Under current regulations, the auditor has a responsibility to report these shortcomings to the audit committee, as well as publicly if the shortcoming is judged to be problematic enough to impact the financial statements. Thus, the modern audit adds value to the company through higher quality information for capital providers. In addition, this process can also create more accurate data for internal decision making in areas such as budgeting and forecasting (as a basis for production and pricing decisions), which can lead to operational efficiencies in inventory management and supply chain decisions.

APPLICATION AND ANALYSIS

How well do these theories help us understand the demand for audit in the modern environment? Above, the theory suggests that the audit provides value to the company receiving it. We also know that prior to the audit becoming mandatory in the 1930s, many companies voluntarily undertook an audit.[vi] Intuitively, this means that there is a **cost-benefit trade-off** to the audit, and if the audit was voluntary, we would expect companies to choose to be audited when the cost is lower than the value received from the audit. The cost of the audit, or **audit fee**, is the amount paid by the company to the audit firm.[vii]

> Why might one company pay more for their audit than another company? Consider Apple and Microsoft. What are the similarities and differences between their business models? Why would one company pay more for the audit than the other?

Economics suggests that in a competitive equilibrium, audit fees should reflect the expected costs of auditor business (or engagement) risk. In the modern business environment, the audit fee will reflect (i) a base level of inherent risk associated with the audit, and (ii) the contracting firm's assessment about the additional risks of the company. Intuitively, the inherent audit risk in the company reflects the work associated with obtaining reasonable assurance for a company. As such, the size of the firm is a logical determinant of audit fees because the size determines the base level of work hours needed to audit the transactions and accounts of a firm. The complexity of the firm, as well as the potential for agency conflicts, increases the audit hours required to obtain reasonable assurance.

In addition, if the demand for audit services increases, either by the firm demanding more services or due to regulatory changes, then the amount of audit fees paid by each company is expected to increase. For example, when the regulator increases the required amount of disclosure in public filings (like the number of items required in 10-Ks and 10-Qs), then the demand for audit services increases.

Modern Financial Reporting Practice

Understanding the modern practice of financial reporting is more complex and nuanced than these theories suggest. The simplified theory that relates agents and principles is far less descriptive of a modern organization which includes multiple individuals with responsibility over financial reporting, including the Chief Financial Officer, Chief Accounting Officer, Controllers, Accounting Directors and Staff. The financial reporting by these teams is overseen by a Board of directors (via the Audit Committee) and by internal audit teams. Figure 1 diagrams modern financial reporting practice, and the next few paragraphs elaborate.

Effective financial reporting governance is a collaborative effort by multiple parties. The governance practices of a company are generally referred to as **corporate governance**. Corporate governance is a set of collective processes and policies that a company institutes to control and safeguard itself, including policies and procedures about financial reporting. Figure 1 provides insight into the collective role of many individuals in creating effective financial reporting governance. Effective corporate governance relies on checks and balances not only internal to the company, but also external to the company, with auditors and assurance providers. We even see governance within audit firms, with national office policies and employees helping support the necessary independence that local engagement teams must maintain.

Technology and systems are crucial to achieving sound financial reporting. Not surprisingly, given the business necessity of accounting information, there is a large market for accounting software with many competing providers. For example, SAP and Oracle are the largest providers in this market, with competition from Microsoft, NetSuite and more recent entrants such as Blackline. Often accounting software is part of a suite of software referred to as the **enterprise resource planning**, or **ERP**, system. The goal of an ERP system is to allow managers to access information about the company's transactions and operations, and optimally, the system can seamlessly integrate information requests from all internal users of the system (e.g., accounting, procurement, finance and project managers all requesting different information). These systems can also implement automated controls in the financial reporting system and help in later assessment of control effectiveness and financial reporting accuracy.

RULE AND STANDARD SETTERS are also crucial to achieving sound financial reporting. Financial reporting in the United States and other developed countries is highly regulated. Modern regulation is far more complex than our historical discussion describes, and many companies employ teams of individuals to ensure the company is compliant with regulations, often led by a **compliance officer**. Compliance teams for a multinational company face challenges stemming from different regulations in different countries. In addition to differences between US GAAP and IFRS, many countries require the use of a different GAAP for statutory purposes, often referred to as **local GAAP**. Local (or country-specific) GAAP is generally used to report to an international regulatory body a financial report that covers transactions done within the country. This process of creating an additional set of financial statements under a foreign GAAP is referred to as **global statutory reporting**.

In the United States, the **Securities and Exchange Commission (SEC)** regulates public companies, i.e., companies listed on public exchanges and companies with more than 2000 shareholders. The SEC was founded in in June 1934 under the 1934 Securities Exchange Act largely in response to the 1929 market crash and subsequent period of economic depression. A central component of the SEC's mission is to protect investors, and the establishment of financial reporting standards is a requirement within that mission. The SEC outsourced most of this task to accounting organizations, with the Financial Accounting Standards Board (FASB) being the current central standard-making body in the US. In 2002, the Sarbanes-Oxley Act required more robust internal control reporting by firms and more intense oversight of auditors. The Committee of Sponsoring Organization (COSO) framework played a key role as the attention to internal controls increased, and the Public Company Accounting Oversight Board (PCAOB) was created to issue auditing standards for audits of public companies and review audit work done for adherence to these standards. Overall, the combination of (1) increasing regulatory requirements within many countries and (2) more global transactions and presence by the average company means that regulatory compliance is a growing part of financial reporting for most companies.

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ENDNOTES

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[ii] This case draws heavily from Wallace (1980) and Wallace (2004).

[iii] Often these contracts will include the terms of compensation, which include bonus pay for meeting a performance target or targets.

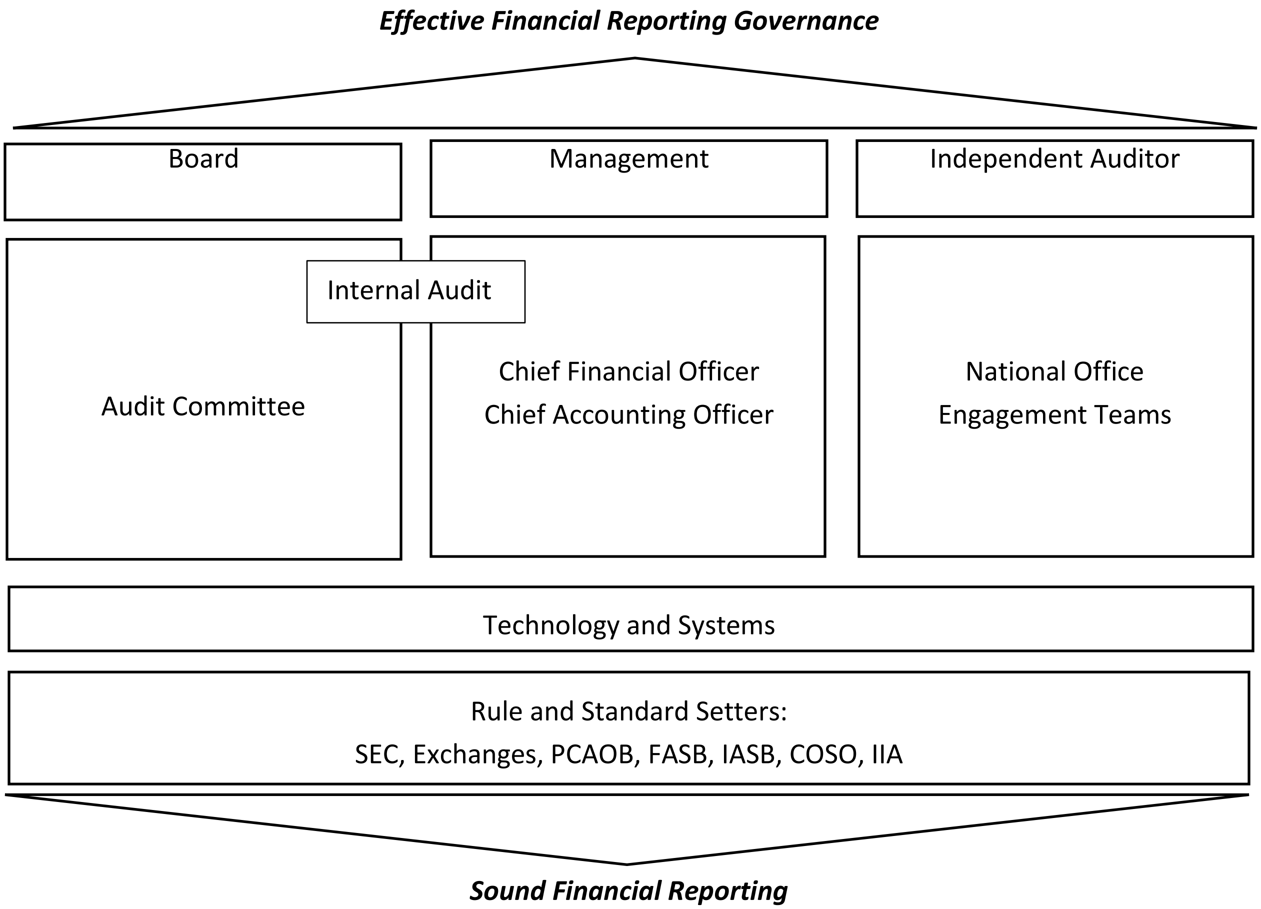
[iv] Abdel-Khalik (1993) provides evidence that private firms use audits to compensate for the manager's lack of control over the company's operations. Carey et al. (2000) find similar results for family-owned firms, and find that internal audit of family firms is used as a substitute for an external audit in many cases.

[v] Importantly independent audits always come with acknowledged limitations regarding the ability of the independent auditor to discover fraud.

[vi] In both Canada and the United Kingdom, mandatory audit requirements for private firms have been made voluntary. Rennie et al. (2003) find that around 73% of Canadian private firms continued to undertake an audit after the change. In the UK, Lennox and Pittman (2011) find that the private firms that undertook voluntary audits obtained better credit ratings, consistent with the audit adding value through assurance over the financial reports.

[vii] Firms also face an economic cost from the audit due to the amount of time that company employees (these days often both in accounting roles and in IT systems roles) deal with requests from the auditor.

Figure 1
A Diagrammatic View of Modern Financial Reporting Practice



Notes: SEC is the Securities and Exchange Commission. Exchanges refer to Stock Exchanges that set listing requirements (including the NASDAQ and the NYSE). PCAOB is the Public Company Accounting Oversight Board. FASB is the Financial Accounting Standards Board. IASB is the International Accounting Standards Board. COSO is the Committee of Sponsoring Organizations of the Treadway Commission. IIA is the Institute of Internal Auditors.