SFB/Transregio 266

ACCOUNTING FOR
TRANSPARENCY

Research on Corporate Transparency

Element 9: Optimal Reporting Standards

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Motivating question

Can theory tell us how to design optimal accounting standards?

Intuitive Answer

No

But it can lead to a more informed discussion

Why not? Meet the Arrow paradoxon

Consider three stakeholder groups and their preferences for three different accounting rules

Stakeholder Group	Historical Cost	Lower of Cost or Market	Fair Value
Equity Investor	(3)	(2)	(1)
Creditor	(2)	(1)	(3)
Manager	(1)	(3)	(2)

For a related accounting classic that shows that fineness it the only context independent concept for ranking information systems see Demski (TAR, 1973).

So:

- An accounting standard can only be considered to be “better” as an alternative standard when it generates finer information, meaning that the information partition of the former is a subset of the latter.
- And this ignores costs of information production

OK. So what can theory do then?

- Given the heterogeneity of users and the heterogeneity of settings, it is impossible to derive normative accounting standards
- Setting standards is ultimately a political task
- However, theory can (again) help to high-light potential mechanisms that allow to identify how the attributes of efficient standards change conditional on specific settings
- This can help political decision makers to understand the trade-off between standards better

An example: Göx and Wagenhofer (JAE, 2009)

1. Firm acquires assets and uses them in normal operations.
2. Investment opportunity requires outside financing. Firm designs accounting system.
3. Accounting system reports information about the value of assets pledged.
4. Firm approaches lender and proposes contract that specifies payments and pledged assets.
5. Firm invests in project if contract is agreed upon.
6. Payoff from project realizes. Contractual consequences obtain.

Efficient impairment based on asset value hurdle ($\hat{A}$)