
Accounting Disclosure and Real Effects

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Abstract

In this paper I advocate and illustrate a new approach to the study of accounting measurement and disclosure that is strikingly different from the usual studies of disclosure in pure exchange economies. This new approach studies the “real effects” of accounting disclosure, arguing that how accountants measure and report firms’ economic transactions, earnings and cash flows to capital markets has strong effects on firms’ real decisions and on resource allocation in the economy. I explicitly study the real effects of accounting for firms’ intangible investments and accounting for firms’ derivatives/hedge activities. I also shed new light on more fundamental accounting issues such as the real effects of imprecision in accounting measurement and the real effects of periodic performance reporting. Studies of real effects have the potential to inform accounting policy debates since they are built around very specific economic transactions and their accounting treatment.

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Introduction

In this paper, I advocate and illustrate a new approach to the study of accounting measurement and disclosure that is markedly different from the usual approach taken in the extant accounting literature. This new approach, which I call the “real effects” perspective, argues that how accountants measure and report firms’ economic transactions, earnings, and cash flows to capital markets has substantial effects on firms’ real decisions and, more generally, on resource allocation in the economy. In most of the extant literature, firms are exogenously endowed with liquidating dividends that are independent of the accounting regime, and the role of accounting disclosure is to provide information about these liquidating dividends. When real effects are present, they arise in one of two ways, contractual efficiency or proprietary costs. The former perspective is that contracts among economic agents with conflicting interests are often based on accounting data and better information makes these contracts more efficient. For example, information provided to a firm’s board of directors for evaluating and rewarding managerial performance could enhance the efficiency of compensation contracts, decrease risk premiums paid to managers, change managerial effort, and hence have real effects. The proprietary cost perspec-

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tive is that disclosures have real effects because they inform competing firms in product markets whose actions decrease the cash flows of the disclosing firm (Dye, 1986; Gigler, 1994). While both these perspectives have merit, they do not address the usual kind of disclosures that accounting standard setters are concerned with — disclosures made to a faceless crowd of investors and traders that collectively constitute a capital market or a futures market, i.e., disclosures made to the public at large. The real effects perspective I wish to develop is that accounting measurements and disclosure matter not merely because they facilitate more efficient contracts with employees and suppliers or because they inform rival firms but, more fundamentally, because the capital market's pricing of the firm is the main vehicle by which the economic benefits of the firm's activities are transferred to the firm's shareholders.

Most traditional studies of disclosure assume that the payoff to holding a firm's shares consists of an exogenously specified liquidating dividend \tilde{u} that is paid by the firm soon after shareholders have bought into the firm. Disclosure to the capital market is modeled as a noisy signal \tilde{y} of the firm's liquidating dividend, e.g., $\tilde{y} = \tilde{u} + \tilde{\epsilon}$. Like any other simplifying assumption made by analytical researchers, the artifact of a liquidating dividend would be justified if it did not throw out the proverbial baby with the bath water, i.e., if it did not preclude a study of the key economic forces that are unleashed by disclosure. I will argue that such is not the case: In fact, much of what is interesting in the study of disclosure is lost by invoking the economic abstraction of exogenous liquidating dividends. Since, realistically, liquidating dividends are almost never paid, investors satisfy their consumption, saving, or liquidity needs by periodically buying and selling firms' shares in the capital market. Thus their payoff to holding shares is determined by the endogenous time path of capital market prices, rather than the payment of liquidating dividends. In turn, this implies that when making its decisions, a firm must be concerned with how those decisions are perceived and priced in the capital market. Thus, not only must market prices reflect corporate decisions and their assessed consequences but also corporate decisions must be affected by market pricing. We should think of the *simultaneous* determination of market prices and

corporate decisions and how *both* are affected by the information contained in public disclosures.

I am not suggesting that the periodic financial statements released by firms are the only source of information, or even the main source of information, to capital markets. A vast community of financial analysts and voluntary disclosure by corporate managers likely inform the capital market on a more timely basis. However, it is difficult to imagine how such information could be learned or verifiably communicated without systematic measurements and records. Since the systematic recording, aggregation, classification, and reporting of the events and economic transactions that affect a firm *is* the acknowledged domain of accounting, we should study the real effects of accounting measurements regardless of the specific channels through which such information is released to capital markets.

A study of the real effects of disclosure can be built around very specific economic transactions and accounting measurements. Such studies can shed light on the following kinds of questions: How does the manner in which we account for firms' derivative transactions change a firm's risk management, speculation and production policies; How does the measurement or non-measurement of intangibles change a firm's mix of tangibles and intangible investments; Does the manner in which we account for executive compensation change the compensation package and the incentives of managers; Does fair value accounting for bank portfolios change its lending and portfolio strategies; Does accounting conservatism increase the efficiency of debt contracting? The answers to such questions have the potential to inform accounting regulators and corporate managers who struggle with alternative accounting standards and disclosure requirements.

Contrast these questions to the issues studied in the extant literature where accounting is viewed as providing noisy signals on a firm's exogenous liquidating dividend. In a recent survey, Verrecchia (2001) described disclosure studies as belonging to one of three categories: (i) Association-based studies that document the effect of disclosure on equilibrium asset prices and trading volume through capital market traders' reassessment of firms' liquidating dividends. (ii) Discretionary-based disclosure which examines a firm's incentives for voluntarily

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disclosing or withholding information about its liquidating dividend. (iii) Efficiency-based disclosure where a firm makes *ex ante* commitments to publicly disclose or withhold information to reduce the costs of private information search by investors or to reduce the information asymmetry component of its cost of capital. All of these studies are conducted in the framework of pure exchange economies where the objects being traded are claims to *exogenously* given distributions of liquidating dividends. In these studies, the effect of public disclosure is simply to move prices, generate trading volume, decrease information asymmetry between informed and uninformed traders, or discourage costly private information search. It is difficult to see how studies of such effects would inform policy debates regarding alternative ways of measuring and disclosing specific economic transactions, or even debates regarding general principles of accounting measurement such as accounting conservatism, imprecision in measurement, or relevance versus reliability tradeoffs. Besides the lack of policy implications, predictions of the price effects of disclosure would be seriously in error if disclosure also has real effects on corporate decisions.

Another strand of the literature views accounting measurement and disclosure as *inconsequential* to both capital market pricing or to corporate decisions. This extreme view of accounting disclosure is best exemplified by the many empirical studies on “value relevance” which assume that alternative accounting measurements only affect the correlation between accounting numbers and observed security returns, but leave the latter unchanged. The value relevance school argues that those accounting measurements that produce higher correlations are more desirable because they are apparently more consistent with the information actually used by investors to determine valuations in the capital market. Similarly, using the insights provided by the Capital Asset Pricing Model (CAPM), Beaver (1972), Gonedes (1976), and more recently Lambert et al. (2007) view accounting signals as providing information on the *true* systematic risk of securities, i.e., on the covariance of a security’s returns with the returns on the market portfolio.

Any advocacy of new research directions must point out the limitations of extant research paradigms. I briefly discuss my view of these

limitations in Chapter 2 and illustrate my arguments in subsequent chapters of the paper. But, for the most part, I focus on surveying some of the work that I have been associated with that concerns the real effects of very specific kinds of disclosures. I do not attempt a comprehensive survey of the extant disclosure literature in pure exchange settings. Such a survey is contained in Verrecchia (2001) and supplemented by Dye (2001). Instead, I dwell exclusively on the real effects approach to the study of disclosure, an approach that is also advocated by Dye (2001), but inadequately discussed in Verrecchia's survey.

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