Discussion of “Why is Financial Reporting So Inefficient?”*

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Hakansson’s paper follows on a theme he has been developing for information disclosure. His interest in examining the consequences of being an uninformed investor led him to conclude the need for mandatory disclosure of quarterly reports (1977). In that analysis, Hakansson suggests that absence of mandatory disclosure creates opportunities for private information search by financial analysts and other specialists for sale to those investors who can afford it. The premise made is that the search for the information which has already been produced but kept private, does not add to the gross national product in real terms. Thus, information disclosure should be mandated with the result being that analysts will have to find other more productive employment opportunities. The same theme was continued in his 1981 article.

In earlier years, Hakansson was content to talk about mandatory disclosure of quarterly reports. Now that quarterly reports are required of registered companies, he carries that theme further. While in the present paper Hakansson does not hold much hope for regulatory reform, his discussion continues to focus on the timeliness and presumed relevance of information revealed through public financial reporting. Financial disclosure in this construction can take on two states: timely, relevant, and comparable disclosure (TRCD), and late, irrelevant and untimely disclosure (LUND). Presumably, if information can be acquired privately at a cost, its subsequent disclosure in financial reporting is LUND. Information will have value only if it can be used to form profitable trading strategies. Thus, it becomes difficult to know what is LUND in reality. If in fact, public financial reporting on a quarterly basis is inefficient and LUND, would a monthly reporting mitigate LUND? How about weekly? It is clear that if one carries the LUND notion too far, we will find that the lapse of any time between the occurrence of an event and its public disclosure is a form of LUND. Stated differently, any time gap longer than is necessary to disseminate the information in the market place can be characterized as LUND. That is, as long as reporting

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events does not instantaneously follow their occurrence, there will be a reporting-use time gap and private investors will find it profitable to invest in information search and acquisition.

The Information Window

Two questions arise in this respect: (1) How frequent should financial reporting be in order to be considered timely? (2) Is there any evidence to suggest that more frequent disclosure will not in fact intensify competition among the well-to-do investors to have early access to private information? Since Hakansson’s paper is concerned with a real-life problem, one can appeal to empirical evidence, including anecdotal observations, to answer both questions.

With respect to the first question, it might be useful to consider the length of time it takes for information to be processed by market participants. In a number of studies, authors have shown that news are fully processed by markets and are impounded in prices within minutes from its arrival. Patell and Wolfson (1984) refer to several such studies and also report their own evidence using the Broad Tape to show that news are processed within few minutes. The evidence on intraday-news trade continues to accumulate and, while researchers are still trying to understand post-earnings announcement drift, no empirical evidence supports the existence of contrary results. Even if we assume that the speed of processing by markets is overly exaggerated and new information takes a full day of trade to be impounded (assuming that many traders obtain their cues from prices), then any financial reporting system that is longer than one full day will create a (time-wise) window of opportunities to trade on private information. As long as the time window between news occurrence and reporting is greater than a few minutes, incentives for traders to obtain informational advantages will continue to exist. Under this scenario, some well-to-do investors will continue to seek the acquisition of private information for their own use.

Furthermore, as the information window gets shorter, it does not necessarily follow that the number of investors seeking private information will decline. Nor does it follow that a smaller number of analysts will be employed to collect intelligence. It is just as plausible that the reverse would be true. More analysis needs to be done for a better understanding of these consequences.

In order to mitigate the Lund effects, the information time-window must not exist. Or, if it exists, must be shorter than the time it takes to disseminate the information in the marketplace. But reporting financial statements on a daily or even a weekly basis will entail higher cost—both to
produce and report, and to use. Even for insiders, the frequent reporting and use of financial data creates a costly information overload. Consider what Harold Geneen, the long-time chairman of ITT, thinks of the resulting information overload.

There is a price to pay, too, as there always is: Paying attention to the numbers is dull, tiresome routine, a drudgery. The more you want to know about your business, the more detail you want to have, the more numbers there will be. They cannot be skimmed. They must be ready, understood, and thought about and compared with other sets of numbers which you have read that day, the week, or earlier that year. (p. 201)

The Briloff Sting!

For the past twenty years, Professor Abraham Briloff has been writing critical analyses of the accounting practices of several companies. Each company-specific analysis was published in a lengthy article in Barron's. The inputs to his analysis come from publicly reported financial statements, press releases by company officials and other publicly disclosed information. Given that all such inputs have been in the public domain, one would not expect that Briloff's analysis would, in an efficient market, result in a serious downward pricing of the stocks of the companies upon whom he chose to base his Barron's reports. But that was not to be the case. Bernstein, a colleague of Briloff at Baruch College, observed (1975) that stock prices of the companies blessed by Briloff's analysis decline sharply on the days the critical articles appear in Barron's. To measure this decline in prices, Foster (1979, 1987) used excess return accumulation (i.e., after removing market-wide variation) to show that the securities market punishes the companies whose accounting practices attracted Briloff's interest—an unexpected average decline of 8 percent on one day. This is the Briloff sting!

The Briloff sting is difficult to explain in terms of financial reporting. It is evident that Briloff had used publicly available information. In fact, he won a legal claim filed against him by one of the affected companies; he uses public information and exercises his freedom of speech. Thus, one cannot blame LUND for the Briloff sting. Nor can the results be explained as a return earned for making an insightful analysis of publicly available data, if capital markets efficiency is the maintained hypothesis. In any case, the "incisive" use of information, which is sometimes offered as an explanation, relates to the use, and not the production, of information. The Briloff sting is clearly a market, information-use phenomenon and replacing
LUND by TRCD would not have altered its shape or existence. That is, even if the information window is an instant, there would be a market for information search and analysis. The Briloff sting shows that even with TRCD, there will be, to quote Hakansson, "rewards to knowledge [private gains which are] generally quite innocuous in appearance."

**The Indicators**

Hakansson presents several interesting observations as indicators of the claim that managers prefer LUND over TRCD. For example, managers are known to resist (1) reporting insider trading, (2) immediate disclosure of significant events, (3) reducing discretionary choice of accounting methods, or (4) improving the comparability of financial statements. These issues are complex and do not have easy answers. Nor do they necessarily indicate that managers favor LUND over TRCD. I would like to note that there is a reporting requirement for both insider trading (within ten days from trade) and significant events (using the 8-k). Both reports are to be filed with the SEC, but can also be obtained by other means (I receive some 8-k reports in the mail from several companies after having asked that my name be placed on their mailing lists). There can be little argument that more dissemination of this type of information is preferred to less, but it is important to note that the mechanism for making such disclosures exists in the present institutional setting.

Hakansson makes a good point in connection with managers' interest in maintaining their discretionary choice over accounting methods. Indeed, several companies are known to have managed income by relying on the flexibility allowed by that discretion. To illustrate, Union Carbide has in 1980 changed the depreciable lives of fixed assets so as to report lower depreciation charges, changed accounting for investment tax credit to the flow-through method, and made prior-period adjustments for the accounting for investment tax credit. All were discretionary accounting changes that resulted in increasing the *reported* net income from $481 to $804 million (Getschow, 1980). The oil and gas accounting standard (FASB Statement No. 19) provides another well-known, and costly, case of management lobbying for a choice of method. Extensive lobbying against requiring the successful-effort method was made by appeal to national interest in motivating companies to search for oil and to drill more wells. The full-cost method was thus favored during a period of growth because managers could, at will, defer charging income with exploration and drilling costs. In recent years, many of these same oil companies have quietly switched from the full-cost to the successful-efforts method. Those same companies that fought
successful efforts earlier now report that the successful effort was found to be "superior." The switch-back allows oil companies to capture prior period adjustments so that they can show higher profits when reported (at full-cost method) and when adjusted (to successful-efforts method) during prosperous and lean years, respectively (Chen and Lee, 1989). Numerous other examples of voluntary accounting changes that smooth, increase, or decrease accounting income are reported in the literature. All are purported to advance the interests of managers (see Watts and Zimmerman, 1986; and Abdelkhalik, 1989).

The real question is not whether Hakansson is correct in saying that managers resist abandoning the privilege of changing accounting methods at will. Instead, the question is really about the consequences. If one accepts that securities markets are efficient with respect to processing public information, then it would not matter what managers do about discretionary accounting changes as long as it is disclosed. It is even remarkable to note that the popular financial press has begun to acknowledge the irrelevance of the choice of accounting methods. In questioning the wisdom of corporate lobbying against the FASB exposure draft on pension accounting that led to FASB Statement No. 87, Christopher Power (1984), the Forbes reporter of the "Numbers Game" wrote the following:

Just because accounting methodology changes doesn't mean the companies have changed one bit. If you accept the conclusion that investors will panic when they see these new numbers, you also have to accept one of two corollaries: Either these investors have been misled for years by traditional methods of accounting, or they simply aren't smart enough to interpret the new numbers properly.

Do Bean Counters Count?

Hakansson's paper includes several other interesting issues related to manager's compensation, management buyout, and reporting by mutual funds. While it is difficult to resist arguing with Nils on some of these issues and their connection to LUND and TRCD, the absence of specific resolutions persuades me to delay further discussion of those points. There are two concluding thoughts, however. First, I would like to caution against falling victims to what I call the Tinker Effect. By attributing significantly more importance to accounting, Tinker (1984) has linked a causal relationship between accounting and national problems such as the Love Canal crisis. While bean counters do indeed matter, they should resist exaggerating the
social worth of their adopted profession. On the other hand, there is magic in bean-counting. As Geneen puts it: Numbers will set you free!

REFERENCES


