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Infrastructure Requirements for an Economically Efficient System of Public Financial Reporting and Disclosure

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[Figures]

THIS PAPER SKETCHES the principal infrastructure requirements for an economically efficient system of public financial reporting (audited accounting information) and disclosure (non-accounting information). Financial reporting and disclosure are complementary means of ameliorating information asymmetry between managers and parties contracting with their firm, including shareholders, lenders, suppliers, customers, and employees. The efficiency of a country's financial reporting and disclosure system therefore is crucial to its development of economically efficient public corporations and public securities markets as well as to the development of its economy.¹

A skeptical view of making sudden changes to reporting and disclosure systems is adopted, due to the economic, political, legal, and institutional complexity involved in effecting actual change. A particularly skeptical view is reserved for simply mandating new accounting standards for public financial reporting. This amounts to little more than "window dressing," unless it is accompanied by wholesale revision of the infrastructure that determines the financial reporting incentives of managers and auditors. If forced to nominate a single place from which to **[End Page 127]** start changing a country's system of public financial reporting and disclosure, I would advocate liberalizing the rules governing stockholder and lender litigation. The risk of litigation motivates managers and auditors alike to increase transparency and, in particular, to disclose bad decisions and report losses in a timely fashion. Many other institutional features--including the accounting standards *actually implemented* by managers and the quality of financial reporting and disclosure *actually achieved*--are determined endogenously by the incentives that managers and auditors encounter. An effective system of private litigation does more to improve actual practice than fiat that is exogenously imposed by governments.

An economically efficient public financial reporting and disclosure system requires the following infrastructure: training an audit profession of adequate numbers, professional ability, and independence from managers to certify reliably the quality of financial statements; separating as far as possible the systems of public financial reporting and corporate income taxation, so that tax objectives do not distort financial information; reforming the structure of corporate ownership and governance to achieve an open-market process with a genuine demand for reliable public information; establishing a system for setting and maintaining high-quality, independent accounting standards; and, perhaps most important of all, establishing an effective, independent legal system for detecting and penalizing fraud, manipulation, and failure to comply with standards of accounting and other disclosure, including provision for private litigation by stockholders and lenders who are adversely affected by deficient financial reporting and disclosure. The scope of these requirements is unavoidably wide, because the accounting infrastructure complements the overall economic, legal, and political infrastructure in all countries.

These infrastructure requirements collectively comprise the important features of a common-law disclosure system. This is not surprising, because the topic of this paper--sketching an economically efficient *public* financial reporting and disclosure system--presumes that information asymmetry (between corporate managers and information users) is to be resolved by public rather than private communication. Arm's-length public disclosure plays a considerably more important economic role in common-law countries than elsewhere, so the infrastructure required to support high-quality public disclosure is more developed in common-law countries such as the United States and the United Kingdom. This does not necessarily mean that it is optimal for other countries to move to a **[End Page 128]** common-law system or that it is politically or institutionally feasible for them to do so. Nevertheless, current interest in the topic of *public* reporting and disclosure arises in part from the attempts (or professed attempts) of a variety of countries and corporations to move closer to the common-law model of public disclosure.

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The first section of the paper describes the criteria for economically efficient accounting and non-accounting disclosure. This involves a survey of the economic and political roles of firms' published financial statements and their relation with non-accounting... **Accept**

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1. See Baumlol (1965); Fama (1970); Black (2000).

127

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