THE ROLE OF CENTRAL RULEMAKING IN CORPORATE FINANCIAL REPORTING

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INTRODUCTION

There has been for almost 50 years a central institution for the promulgation of financial reporting rules (Generally Accepted Accounting Principles). The public accounting profession has regarded it as a professional responsibility to establish these "rules of the game" governing the behavior of both corporate management and their auditors. Through most of this period, the rules were voluntary guides to the choice of appropriate accounting methods, backed up by the implied threat of the Securities and Exchange Commission to make mandatory rules governing financial reporting. Over time, the voluntary nature of the rules gradually eroded; now these official pronouncements are generally recognized to be binding on management and auditors. They have thus changed in character from the "friendly advice" of experts to something more like laws mandating relatively specific behavior.

Given that such an institution exists, it is important to be able to explain why it should have arisen, and what its function is. It is noteworthy, then, that the question of the justification of the rulemaking institution itself has received so little attention. The explanation may be that only relatively recently has the institution (by now, the Financial Accounting Standards Board) evolved into a form that calls for justification. It can be argued that the Committee on Accounting Procedure of the American Institute of Certified Public Accountants was (especially at first) a passive body with no real power, except the ability to keep the Securities and Exchange Commission from actively making financial reporting rules. More recently, however, the nature of the institution's role has changed into a form which makes its existence and activities more in need of justification. As noted above, its promulgations are, practically speaking, recognized as mandatory for firms and auditors. Furthermore, the content of the rules themselves--and therefore the process through which they are promulgated--has

come to be a matter of great concern.

In any case, most of the work that has been done on the problem of the justifiability of an institution is negative, in the sense that it starkly demonstrates that a justification has not been given. Indeed, to the extent that some of these analyses are correct about the role and activities of the rulemakers, one may question whether the process has any legitimacy at all.

This paper provides an explanation of the existence of a financial reporting rulemaker, by providing a justification of its existence. A justification, in the present instance, gives reasons why securities market agents should have unanimously agreed to have a financial reporting rule-maker as part of the structure of the securities markets.[1] Furthermore, the reasons why this choice would be made are based on a consideration of their own individual interests. Altruism and envy are not considered. The basic idea is that securities market agents would find a rule-maker's existence in their own interests. That is, opting for a rule-maker is the best course of action for them. According to the argument given here, securities market agents would freely agree to have a third party (the central rule-maker) adjudicate conflicting views regarding the specific financial disclosures which corporate management is to make to investors and potential investors. By so doing, the rule-maker establishes the specific rights and obligations of securities market participants. The rule-making process is then part of the infra-structure of the securities market itself, just as are specialists, rules against insider trading, and laws against fraud. The institution is thus <u>not</u> an interference in the securities market (as some might suppose), preventing participants from making direct, voluntary determinations of financial reporting practices in equilibrium. Rather, it serves to create a more nearly ideal securities market (at some cost) by reducing information asymmetries, increasing the homogeneity of securities, and selecting (in view of the public

good nature of financial information) what it regards as an optimal level of information quality.

The problem of the justifiability of a rule-maker is thus regarded as a sort of constitutional problem, relating to the basic structure of an important social institution--the securities markets--rather than as an economic problem of determining a least cost (most efficient) system of information disclosure per se. Thus, the analysis given here has more in common with, say, Buchanan and Tullock [1962] than it has with conventional information economics (e.g., Demsetz [1969]).[2]

Part I is a critical examination of recent work in the accounting literature which concerns the institutional structure of financial reporting. Part II provides an analytic argument for the existence and role of a rulemaker for financial reporting of the issue.

I.

Current analyses of the role of central rule-making in financial reporting [e.g., Gonedes, Dopuch, and Penman, 1976; Jensen, 1976; Jensen and Meckling, 1976; and Watts and Zimmerman, 1979] focus on the role of the rule-maker (e.g. the Financial Accounting Standards Board) in the context of the securities markets. Their approach is to take as given the basic structure of the securities market, in which securities (consisting of risk-return bundles) are freely traded with a minimum of interference. The question then is: should a central institution for making financial reporting rules be appended to this basic structure? For example, according to Beaver and Demski, "The structure of the [securities] market will ... bear on the issue of the optimal form of information regulation (e.g., whether the market mechanism should be used to make information decisions in the economy.)" [1974, p. 172, fn. 2].

Gonedes [1975] postulates the existence of a market for information, within the fixed structure of the securities market. [See also Gonedes and

Dopuch, 1974; Gonedes, Dopuch, and Penman, 1976]. In this hypothetical market, securities market agents are able to form coalitions for the purchase of information from the management of firms. It is then shown that a competitive outcome to the production and discrimination of financial information occurs, and that it is Pareto-efficient.[3] From this, Gonedes concludes:

> In the absence of additional assumptions, there appears to be no economic motivation for the disclosure laws [i.e., financial reporting rules]. Indeed, since the legally imposed information-production decisions are feasible but not necessarily optimal, the disclosure laws may induce a suboptimal allocation of resources to the production of resources. [1975, p. 859]

The point of this is, of course, that the legitimate existence of a central rule-maker is being called into question. Gonedes mentions several other rationales for the existence of a rule-maker, but finds them insufficient. Thus, as he notes, its legitimacy is an open question, its existence as yet unjustified.

It should be clear that Gonedes has simply reproduced the "Invisible Hand" Theorem of classical micro-economics. In so doing, he has defined an ideal Pareto Possibility Frontier. It is ideal in the sense that it is a result concerning the limiting case where a set of vitally important counterfactual assumptions are made. If there were an ideal market for financial information about widely held corporations--meaning that financial information is a pure private good, that information transactions are costless, that there are many buyers and sellers, and that there are no adverse selection problems brought about by the conflict of interests between the managers and owners of widely held corporations--then securities market agents would maximize their expected utilities by participating in this information market. A rule maker could do no better.[4]

But such a proof is just irrelevant to the problem of the desirability of

alternative institutional frameworks.

Corporate managers apparently do use their control over financial information in their own interest, to the disadvantage of investors;[5] financial information is a public good;[6] and the costs of collectively determining the disclosure of financial information--whether via a rulemaker or an information market--are substantial.[7]

The use of formal methods has the obvious advantage that it can produce determinate results. But there is the equally obvious danger that the simplifying assumptions required to achieve these results are too "heroic." If this is the case in a given situation, then the interpretation of the results (i.e., their importance for understanding that part of the "real world" [the referent] which is supposed to be their domain) is questionable. It might be argued that the extent to which Gonedes' assumptions obtain in "the real world" is an empirical question, and that his theorem holds as a limiting case. But this ignores the fact that the appropriate mode of analysis (and, in general, the results of the analysis) changes substantially when Gonedes' assumptions are relaxed. For example, Coase's Theorem demonstrates the power of the transaction cost assumption for the analysis of externalities.[8] In essence, Gonedes has given a zero-sum solution to a positive-sum game. Given that there are interdependencies among securities market agents, and that transaction costs prevent the attainment of an ideal Pareto-efficient resolution of those interdependencies, the question to be answered is: Given the interdependencies and transaction costs, would it be more in the interest of securities market agents to have financial disclosures governed completely be a market process, or governed at least in part by a rulemaker? Treatment of Gonedes' proof as relevant to the institutional choice problem is the "nirvana approach" criticized by Demsetz [1969].

The agency approach, as typified by Watts and Zimmerman [1978], [1979],

Jensen [1976], and Jensen and Meckling [1976], is an attempt to answer this question. It does so by relaxing some of the assumptions made by Gonedes. An agency relationship is defined as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." [Jensen and Meckling, 1976, p. 308]

There are four main theses in the agency approach to financial reporting, all rooted in economic theory. First, the market value rule assumed by Gonedes is relaxed, allowing the existence of conflicts between the managers of a widely held corporation and the suppliers of equity capital (hereafter, owners).[9] Second, the cost of making and enforcing agreements is costly (non-zero transaction costs). This includes the cost to the principal of monitoring the agent's actions. An essential part of monitoring includes the provision of financial information by the latter to the former. These costs are an additional agency cost, the consumption of resources required in order to have an agency relationship in the first place.

The third component of this approach to the provision of corporate financial information is a theory of regulation. Since the issue is the relative desirability of market-determined financial disclosure and rule-governed financial disclosure, a theory of rule-making (regulation) is obviously relevant.

One view [e.g., Watts and Zimmerman, 1979; Jensen, 1976] is based on a belief that all participants in the regulatory process--including the regulators--act in their own perceived self-interest.[10] The importance of this, of course, is that (according to this view) we should not expect regulators to act impartially, either in "the public interest," or, in the interest of individuals. Indeed, the interests of some individuals (i.e., those whose interests do not happen to coincide with, or cannot be made to

coincide with those of the regulator) may be better satisfied if they are able to act on their own account, without the interference of the regulator.

The fourth component is an emphasis on the role of property rights in voluntary agreements concerning the allocation of resources. a right may be defined as "a legally enforceable claim of one person against another, that the other shall do a given act or not do a given act." [Hirsch, 1979, p. 8] A property right is a right to hold or use property in specific ways. The concept of a right is a legal concept, and thus is restricted to legal contexts, within the context of a system of property laws. [Hirsch 1979, p. 20] From a purely economic point of view, property rights aid in the process of efficiently allocating resources. This occurs via the market mechanism, through which property rights are either temporarily or permanently transferred from one individual to another. Thus, through the purchase and sale of the rights to hold and use property, things of value are assigned to their "best" (utility-maximizing) use.[11]

Property rights are especially important, according to the theory, when it is recognized that there are costs of making and enforcing agreements. For the economic effect of property law, according to Hirsch [1979, p. 13], is to reduce transaction costs. Thus, to the extent that a property rights system is efficient, it helps society reach a higher Pareto-efficiency frontier (than would obtain if there were no such system). The Coase Theorem states that, if transaction costs are zero, a Pareto-efficient allocation of resources will occur, regardless of the initial assignment of property rights. But, if transaction costs are greater than zero, they can be reduced by an "appropriate" assignment of property rights.

The agency approach goes beyond Gonedes' analysis in its emphasis on the distributional impact of financial reporting rules and rule-making. Gonedes raises the issue of whether a market for financial information would be more

efficient than a rule-making institution. The distributional consequences are not examined. [See also Gonedes and Dopuch, 1974; and Gonedes, Dopuch, and Penman, 1976] But Jensen, for example, is clearly against constraints on the permissible transactions among individuals (investors and managers).[12]

As Beaver and Demski [1974] recognized, changes in the body of financial reporting rules do affect the distribution of wealth. In particular, forced disclosure would be expected to increase the wealth of investors and (free-riding) potential investors, and to decrease the wealth of the managers, who (up to that point) controlled possession of the information in question. Indeed, any central resolution of an externality should be expected to have this effect. Beaver and Demski's social welfare orientation is that a change in financial disclosure, e.g., the adoption of rule R, would be justified if it puts society on a higher Pareto-efficiency frontier. Such a move is permissible even if the outcome is not a Pareto-superior to the previous allocation of resources. Movement to a Pareto-superior is not precluded, and indeed, should occur if a change in financial reporting is to the (net) benefit of both investor and manager groups. This could occur if managers were willing to disclose a given kind of information, but only if the managers of all comparable corporations do so at the same time.

According to the property rights approach, movement to a higher Pareto possibility frontier is allowable only if it is a movement to a Pareto-superior. Then, changes in financial reporting rules, which would result in a re-distribution, could occur only if compensation is paid to the "losers." In this way, Pareto efficiency is preserved. [See, e.g., Jensen and Meckling, 1976; Sunder, 1980]

But, then, why have a rule-maker if investors and managers could have agreed on rule R with a mutually acceptable side-payment? [cf. Gonedes, Dopuch, and Penman, 1976] Furthermore, since the rule-maker would have to

decide on the amount of compensation, what reason is there to believe that it would select a payment that would have obtained in a market setting? According to this line of argument, a rule-maker would be legitimate (justifiable) only if it turned out to minimize the cost of reaching Pareto-efficient financial disclosures -- that is, if it acted as a mediator among securities market agents, enabling them to reach agreement at lowest cost. Its only legitimate role would be to produce what would have been the market equilibrium (if a market had been feasible) at a lower cost than would be consumed by a market for financial information. That is, a rule-maker should only exist as a market surrogate, in the sense that it does only what an information market would have done, and at lower cost.[13] But, on this line of thinking, a central rule-maker would be illegitimate to the extent that it effects re-distributions.

It is a liberal axiom of our society that individuals should be left free to arrange their plans of life as best they can, free of unnecessary restrictions imposed by society. Perhaps a financial reporting rule-maker is an unnecessary infringement on people's ability to act in their own interest in obtaining financial information. The possibility is suggested by Gonedes, Dopuch, and Penman [1976], and pursued by the advocates of the agency approach, that a suitable change in the assignment of property rights to financial information could make a financial information market feasible.[14]

The operational problems of a functioning financial information market are manifold. At the same time, one should expect that a market of some sort would arise, with all its imperfections. Still, the question is, why is this not better than a central rule-maker?

Sunder [1980] provides something of an antidote. Using the notions of property rights, compensation and bargaining, he argues that -- given the choices made by a financial reporting rule-maker -- securities market agents

would adjust their activities in such a way -- that (relative) efficiency may be expected, but not guaranteed.

But Sunder addresses only briefly the issue of the desirability of alternate institutional frameworks for financial disclosure, in particular that of a rule-making body of some sort. In the main, he assumes (p. 13) that a rule-maker exists, and considers alternative methods of rule-making, and the decisions that individual securities market agents would make in a rule-governed financial reporting system.

It may be granted that a rational securities market agent can make utility-maximizing adjustments to any new rule or rule change. The question remains: why would he want rules in the first place?

The efficiency considerations advanced above provide some reason for such an agreement. But what about the equity (distributional) considerations? Why would they agree on a set-up which will produce redistributions of wealth? This question is particularly difficult to answer for managers, who possess financial information of the corporation, regardless of who does or might or should own the property right to it. Since the evolution of financial reporting rule-making is toward more complete disclosure, it is clear that they would not all favor the promulgation of rules which limit their freedom to report what (if any) information they wish.

II.

The argument which follows is an answer to these questions; it is fully compatible with the basic assumptions of the agency approach, particularly the rejection of the market value rule, the existence of substantial agency costs, and the belief that actions resulting from voluntary choices by individuals acting in their own self-interest is ceteris paribus preferable to actions mandated or constrained by a central authority. Furthermore, it is consistent with the property rights/agency emphasis on contracts unanimously agreed upon

be securities market agents.

The argument is that securities market agents would unanimously agree to have a central financial reporting rule-maker, delegated to make rules in accordance with which all are obligated to act. This is in spite of the expected distributional effects of the rule-choices.

The present analysis focuses on the role of a financial reporting rulemaker in the securities market. Fama [1980] has emphasized the importance of the managerial labor market as a control over the freedom of corporate managers to act in their own interest. Thus, it might be thought, the need for a financial reporting rulemaker would be less clear. Two things may be said in response to this. First, the role of the securities market in the managerial labor market is in all probability substantial (even if, as Fama says [p. 295], it is not the whole story). Second, the interests of managerial labor market agents conflict in just the same way as those of securities market agents--indeed, it is the same conflict. So, the argument given here regarding the securities market applies directly to the need for a financial reporting rulemaker for the managerial labor market.

It is important to be clear from the start about the logical strength of the argument. The argument I will make is intended to provide sufficient grounds for saying that a central rule-making institution would be agreed to by all securities market agents, under the conditions specified in the argument.

But, it is not sufficient to imply that any rule-maker would be better than any information market. For one thing, if Watts and Zimmerman [1979] are right (or to the extent that they are right) in their account, it may well be that an actual rule-making institution could be doing such a bad job that all securities market agents would agree that it should be abolished. On the other hand, they might all agree, not to abolish it, but to reform

(revolutionize?) it. Even if a central rule-maker exists as the unanimously chosen institution, it still cannot be guaranteed that the rules chosen by it are Pareto-efficient. [Sunder, 1980] That is, even with Pareto-efficiency as a goal, specific rule-makers may fail to achieve it, e.g., through ignorance, miscalculation, by acting in their own self-interest, or because the cost of regulation exceed the benefits.

In short, the desirability of actual institutional structures for financial reporting rests in part on contingent (empirical) issues, which cannot be settled here. In any case, to the extent that, e.g., Watts and Zimmerman's [1979] claims regarding financial reporting rulemaking are correct, the need is all the greater to figure out what (if any) legitimate role such a rulemaker is supposed to be performing. For, without such an analysis, no grounds for criticism of their behvaior would exist. Therefore, while the argument justifies the existence, and characterizes the role, of a financial reporting rulemaker, it neither defends nor attacks the actual workings and results of financial reporting rule-makers. In showing what they are supposed to be doing, it does not judge or presuppose that they are in fact doing either a good job or a poor job.

Furthermore, claiming that there is a legitimate role for a rule-maker for corporate reporting, and that therefore corporate disclosure of financial disclosure should not be completely voluntary, there is no implication that voluntary disclosure by corporate management should be eliminated altogether. Nor does it imply that a "secondary market" for financial information (e.g., subscription services and the analytic services of securities brokers) should be proscribed. Indeed, such voluntary arrangements may be helpful to a rule-maker in attempting to make good rules.

The problem facing securities market agents is best regarded as the choice between alternative structures of the securities market -- taking a

system of financial disclosure as a part of the structure of a securities market — rather than directly as the choice of a financial disclosure system. There are two reasons for this. First, the primary interest of securities market agents is the securities market itself, i.e., the system through which they make investment-consumption trade-offs. Financial information is valuable to them only insofar as it aids them in making rational (informed) investment decisions. Therefore, the institutional structure through which financial information is provided to them is only a secondary concern. To consider the institution of corporate reporting in isolation from the securities market to which it is subordinate runs the risk of sub-optimization: even if a rule-maker were a more costly way system of corporate disclosure, securities market agents might be better off with a securities market which includes a rule-maker.

Second, such a characterization of financial disclosure lends credibility to the view that financial disclosures by corporate managers might actually be determined via a market process. For, it is unlikely that a separate, identifiable market for manager-supplied information -- as opposed to such secondary sources as brokers and investment letters — would be feasible. On the other hand, it does make sense to say that corporate policies for public disclosure of financial information would be a factor in determining equilibrium security prices. For example, all members of the steel industry might settle on standard reporting practices.[15] Thus, without embedding the "information market" as an inseparable (though perhaps analytically distinguishable) part of the securities market, the non-rule-maker option for corporate financial reporting is not well-defined.

The argument shows why securities market agents would unanimously choose to follow the dictates of a financial reporting rule-maker, by showing why a <u>representative</u> securities market agent would choose to have a securities

market, part of whose structure includes a rule-maker, rather than a market lacking a rule-maker.[16] If all securities market agents are like the representative agent in relevant ways, then the choice would be unanimous. This is done by postulating a situation of relative uncertainty, wherein a securities market agent is uncertain about his or her own position in the securities market. This serves to isolate the special interests of particular securities market agents, which depend on their specific positions in the securities market context. Then, the representative individual is also a disinterested individual, not having a special pleading, but choosing with a view to what is in the common interest — the public interest criticized by Watts and Zimmerman [1979].

The argument is in two stages. First, it is argued that a representative individual would want to have a Pareto-efficient securities market. This is not as obvious as some might suppose. This step is important for both advocates and critics of rule-making, for the latter presume that efficient disclosure would result if securities market agents were left free to make their own arrangements regarding financial information. If some individuals would benefit from inefficiency, then efficiency would seem less likely to occur.

The second stage of the argument is to explain how having a rule-making institution for financial reporting as part of the structure of the securities market helps it to be more nearly ideal than it would otherwise be.

A. The Pareto Efficiency of a Pareto-efficient Securities Maarket

The following assumptions are made concerning the knowledge of securities market agents about the securities market.

(1) Regarding securities market (investment and financing) decisions, securities market agents are all known to be risk-averse expected utility maximizers. The use of financial information is an essential component of

their maximizing strategy. Furthermore, each individual is egoistic, in the sense that securities market transactions are made without regard for their effects on anyone else's utility. In particular, externalities imposed on others are ignored.

(2) All securities market agents have an understanding of economic theory, especially concerning the workings of markets and their role in the allocation of resources. This means, among other things, that they understand the desirability of a Pareto-efficient market, both in terms of the allocation of resources, and in terms of their resulting ability to act independently of one another.[17]

(3) Securities market agents know that the securities markets exist in a complex and dynamic environment, both politically and technologically. Therefore, events may affect the functioning of firms in ways that cannot reasonably be anticipated. For this reason, information needs of investors may be expected to change, continually and perhaps rapidly, and in unanticipated ways.

(4) There are two kinds of securities market agents: investors and potential investors on the one hand, and managers (of widely held corporations) on the other. Members of the two classes have conflicting interests regarding the conduct of the corporation. Investors have certain rights regarding corporate activity, including the power to retain managers, and to determine their remuneration. Managers have corresponding responsibilities to investors, to act in the interest of the latter.[18]

The main difficulty, of course, concerns this last assumption. It is not difficult to argue that investors and potential investors would prefer a securities market in which the conditions of the invisible hand theorem were met. Given that a securities market exists for the allocation of financial resources, investors could do no better than to have an ideal market. But it

is not so simple in the case of managers. To the degree to which the market value rule holds, there is no problem. Even in the conventional agency framework, it could be argued that managers would desire an ideal securities market, since it is in their interest to minimize agency costs.

The problem with such an argument is that it ignores the incentives of managers to deceive investors (and to deceive managers of other firms),[19] in virtue of their control of the firm's information system. In the immediate context, this means that managers have an interest in a sub-ideal securities market. In both the acquisition of capital, and in terms of the managerial labor market (hiring, remuneration, and retention), it is to managers' advantage to disclose information to investors which puts them in the best possible light. In the absence of institutional strictures against deception, there is no reason (beyond the consequences -- if any -- to their self interest) for managers not to practice deception.[20]

The incentives of managers regarding the disclosure of financial information tend to produce a sub-ideal securities market in several ways, to be discussed below. One general effect is relevant to this part of the argument: deceptive financial information violates the fundamental assumption of economic analyses, that economic behavior is completely voluntary. Intentional deception is, like violence, a form of coercion. [Bok, 1978, p. 18] The receiver of an intentionally deceptive message is not merely unable to act in ways he or she would act, if given a nondeceptive message: he is prevented from doing so. That means that he is not completely free in his actions. That is, they have an involuntary element. This lack of freedom is central to the topic of deception.

Because of the relationship between deceiver and deceived, lack of freedom changes the distribution of power between them -- more to the former, less to the latter. [Bok, p. 19] The value of financial reporting is

supposed to be that it aids the receiver of the information in making decisions, the benefit thus accruing to him. But the value of intentionally deceptive information lies in its benefit to the sender, primarily. Indeed, the purpose of deception is just to affect the relative power of people (here, securities market agents).[21]

Because of the conflicting interests of securities market agents, and the intrusion of coercion, we have the problem of rights, and the specification of who is to have them. This does inject ethical considerations into the argument. But no more than that introduced by the property rights analysts, whose concern is that a financial reporting rule-maker may prevent or limit the scope of voluntary behavior. At a minimum, and consistent with the economic approach, we may say that the readers of financial reports have a right not to be deceived. The principle of Veracity, going back to Aristotle, states that "lying is 'mean and culpable' and that truthful statements are preferable to lies in the absence of special considerations." [Bok, p. 30] The point of this is that lies are not neutral; there is a presumption against lying. This presumptive right not to be deceived may be overridden, e.g., by the priority of a conflicting right of someone else, or by consent freely given. But the burden of proof or justification is on the would-be deceiver, whereas truthfulness does not ordinarily require any justification.

Deception (and even the likelihood of deception), then, is an interference in the free functioning of the securities market, resulting in a market which would be less than ideal. But, if managers would benefit from such a market, why would they agree on something different? Presumably, they wouldn't.

But consider a representative securities market agent — one who could make a disinterested choice. Such a person is conceived to be representative of all securities market agents in that any one could be chosen arbitrarily,

and would make the same choice regarding the ideality of the securities market. By making securities market agents ignorant of their individual characteristics which produce the conflict of interest, those characteristics causing them to have special (private) interests in the structure of the securities market are eliminated. In this way, a unanimous choice is possible.

Thus, an additional assumption about the knowledge of securities market agents is made:

(5) Securities market agents are ignorant of their own position in the securities market. Specifically, they have no information about whether they are investors or managers of corporations. Furthermore, they do not know about their endowments of wealth or abilities, including their ability to bargain (or threaten) in a market situation.

This assumption introduces a "veil of ignorance," behind which the choice of institutional structure is to be made. The veil of ignorance idea was developed by Harsanyi [1953] and Rawls [1971], in their efforts to develop basic ethical theories, concerning the appropriate bases for evaluating and chosing among alternative social institutions governing collective activity.[22]

The degree of uncertainty of the choice situation raises the question of the appropriate decision criterion to be used by a representative securities market agent in the choice of a market structure. Two possibilities stand out in the decision theory literature. One is to maximize expected utility, which presents the problem of assessing the probabilities that various states of affairs -- here, concerning the identity of securities market agents as investors or managers, and the distribution of endowments and abilities -- will obtain. Under the assumptions made, there is no non-arbitrary way of doing so. The principle of insufficient reason (the Laplace rule) [see, e.g.,

Luce and Raiffa, 1957, Ch. 13] according to which each state of affairs is considered to be equally likely, does allow the expected utility approach to be applied, there is little more to be said for it. In particular, the assignment of probabilities (1/n to each of the n states of affairs) is sensitive to the specification of states affairs. So, even to generate these arbitrary numbers requires information which is not available to the participants.

In any case, the assumption that securities market agents are, in making securities transactions, expected utility maximizers does not imply that they should be expected utility maximizers for institutional choices as well. And, in view of the uncertainty of the situation, the importance of the decision [Rawls, 1971, p. 169], and the risk-averse nature of the individuals, a more conservative rule would be more appropriate.

Such a decision rule is the minimax rule, according to which individuals are to choose so as to minimize the maximum loss; in other words, expect the worst, and act accordingly. Because of the radical uncertainty implied by the veil of ignorance, this is the apropriate rule for choosing the structure of the securities market.

If, as argued above, control of corporate information by managers gives them an advantage over investors via the possibility of deception, then a securities market in which deception is practiced is systematically biased against investors. An individual who knew himself to be a manager would prefer such a market, while an individual who knew himself to be an investor would prefer an ideal market. In the face of uncertainty, the minimax rule counsels individuals to choose as if they knew themselves to be investors. Therefore, the choice of a representative securities market agent would be an ideal market, one which is unbiased (symmetric) with respect to whether one is an investor or a manager.

One might try to extend Sunder's [1980] expected utility argument to the institutional choice problem. Such an argument would have a representative securities market agent, behind the veil of ignorance, calculating the expected utility of alternative securities market structures, and choosing accordingly. But there is no non-arbitrary way of assigning probabilities to the outcomes, and of characterizing the (number of) outcomes. Therefore, the expected utility argument does not yield a determinate choice. Once an institutional structure is chosen, Sunder's own analysis is meaningful (since information is available on which to assign probabilities) and relevant (since it relates to individuals' incentives to change their own roles within a market structure).

B. The Pareto Efficiency of Financial Reporting Rulemaking

Given that disinterested securities market agents would unanimously prefer an ideal securities market, why would they prefer a securities market which had a financial reporting rule-maker as part of its structure? The general answer is that they would prefer it if it would produce a more nearly ideal securities market. The relevant aspects of the securities market are, and the task of a rule-maker would be, to make it more nearly perfectly competitive, and to remove externalities.

The existence of an externality is a sign of the existence of transaction costs and imperfect information, which prevents its internalization via market transactions. [Dahlman, 1979] Public goods are, of course, one cause of externalities. Since publicly available information is a public good, some mechanism for producing a Pareto-efficient system of financial disclosures is a necessary condition for an ideal securities market. The preferability of a securities market with a rule-maker is, on this ground, partly an empirical question, and thus indeterminate analytically.[23] It might seem then, that we

are at an impasse, being unable to conclude that the inclusion of a financial reporting rule-maker has the ability to cause the securities market to be more nearly perfectly competitive -- that is, to better satisfy necessary conditions for it to be an ideal allocator of resources. Then, any securities market agent would desire to have a financial reporting rule-maker as part of the structure of the securities market.

The securities market is really a set of markets, where each security has a separate market. The degree to which the securities market can be considered to be a single market depends on the homogeneity of the securities. Conventionally, securities are assumed to be risk-return bundles; information about them is not mentioned, presumably because it is exogenously given, and reltively homogeneous across securities. But when the structure of the market itself is at issue, the system of financial disclosure is also at issue. Therefore, in the current context (that of choice of a securities market structure), a more adequate view of the securities market is that the commodity in question is not the conventional two-parameter (risk and return) security of finance theory, but a three-parameter commodity, including the quality of information disclosed by the firm about itself as a third parameter. Without adequate information regarding a firm, investors and potential investors are prevented from making adequately informed decisions. And since financial information is largely under the control of corporate management, it needs to be regarded as a separate characteristic of securities, the commodity (ownership interest) which is bought and sold.

Information quality has received relatively little systematic attention.[24] Although evaluation of this literature is beyond the scope of this paper, several points do need to made. One is that, in the context of investment decisionmaking, the quality of information about firms is of primary interest to investors and potential investors. This underlies much of

the profession's concern with the adequacy of financial statements.[25]

A second point is that, without common standards of reporting, such as financial reporting rules, the quality of information of various firms would doubtless vary. The extent of variation is unknown, since we already have financial reporting rules. Since the commodities bought and sold in the securities market are homogeneous only to the extent that the quality of information disclsoed by them is homogeneous, the conditions of perfect competition are better met by the securities market to the extent that information quality is homogeneous.

Furthermore, if financial reporting rules are chosen with regard to information quality, as is clearly the FASB's intention [1980], then the rules serve as a standard of minimum information quality. Therefore, they cause securities to be more homogeneous than they would otherwise be. That is, they have the consequence of making the securities market more purely competitive.

An additional issue relating to information quality results out of managers' control of corporate information, the divergence of their interests from those of investors, and from nonhomogeneity of financial information (in the absence of a rule-maker). It is the "lemons" problem [Akerlof, 1970], resolution of which can be accomplished by a financial reporting rule-maker.

In the case of the securities market, the good in question is securities; the lemons problem involves uncertainty abou the quality of securities. According to the conventional view of finance, as discussed above, the securities of various firms (composed of risk and return characteristics, and in the context of portfolio theory) are close substitutes for each other. From the point of view of a price-taking individual investor, securities (considered as risk-return bundles) do not vary in quality, since (from his point of view) return is a function of price, which (assuming that the securities market is efficient) is an unbiased estimate of a firm's value in

relation to all other securities. Higher returns accompany higher risk: together, they imply that securities are of homogeneous quality,[26] and thus that the lemons problem does not arise.

A second interpretation is based on the analysis of securities presented above, as consisting of risk, return, and quality of information about the firm. On this view, a security is of better quality (ceteris paribus) if risk is lower, return is higher, or information quality is higher.

As discussed above, in a securities market unregulated with regard to financial reporting, information quality would vary; therefore, the quality of securities would vary. The level of information quality for a firm would be the result of the ability of its manager to freely choose accounting methods in the preparation of financial statements. Because of the structure of the manager's incentives, he will choose a level of information quality that best satisfies his own interests, rather than that level which would maximize the investor's interests. The reason for this is that the level of information needs to be defined with regard to the receiver's purposes, rather than the sender's purposes. The investor has two sources of uncertainty (besides the sources usually discussed in finance), then, regarding the quality of a firm's security: uncertainty about the manager's interests [cf. Ronen, 1978], and uncertainty surrounding the ability of various accounting methods to represent the affairs of various firms.

As a cause of market inadequacy, the lemons problem relates to market imperfections in two ways. First, information asymmetry violates the assumption that all market agents have equal and costless access to information. Second, it affects the size of the market, which relates to the assumption that there are enough market agents, so that they all act as price-takers. As Akerlof shows, a market in which there is information asymmetry can disappear altogether. The market effects of asymmetry result in a less-

than-Pareto-efficient allocation. Thus, if one is interested in securities markets as an efficient allocator of real economic resources to firms, then one would be interested in reducing or eliminating the asymmetry. By controlling the quality of financial information provided by corporate managers, and therefore the asymmetry, a financial information provided by corporate managers, and therefore the asymmetry, a financial reporting rule-maker would help produce a more nearly ideal securities market.

The above argument concerns dealings in individual securities, and the attendant role of a rule-maker. Information asymmetry also has a general effect on investors. It is perhaps not obvious that, at another level, the lemons problem is itself a public goods problem. In the analysis above of the relationships among investors, and between investors and potential investors, the public good nature of financial information was seen to cause externalities. Here, in the relationship between investors and managers, the public good is not information, or even the quality of information for specific firms; it is the average quality of the good, or some other market statistic used by investors and potential investors in deciding to buy or sell shares.[27]

Therefore, from the point of view of investors, there exists a Pareto-efficient (aggregate) level (expressed, e.g., as an average or a minimum) of information quality for firms taken as a whole. In other words, while homogeneous information is a necessary condition for an ideal securities market, it is not sufficient for Pareto-efficiency in a larger context — we have to have the optimal amount of the public good. Since the problem arises results from the conflicting interests of owners and managers, and the latter's control of the corporation's information about itself, a rule-maker is needed to reach that level.

Summary and Conclusions

A. The arguments given in Part II appear to conflict with the property rights approach, according to which it is both feasible and desirable for property rights to financial information to be assigned to some securities market agents. Under specified conditions, a Pareto-efficient system of disclosure is claimed to result via market transactions. Among other things, it is vital that the right be freely transferable, so that there are no impediments to it reaching its best use. Such information rights transactions would be purely voluntary. On the other hand, a rule-maker's task is to promulgate rules which (in any non-trivial case) will involve re-distributions of wealth, and restrictions on the ability of individuals to make mutually satisfactory agreements.

The argument was that securities market agents would agree to such results, in the domain of financial disclosure, in order to achieve a more nearly ideal securities market. A rule-maker is considered to be part of the structure of that market, just as are laws against fraud and margin requirements. In addition, it is not legitimate to regard it as an appendage to, much less an interference in, an otherwise free market. There is no such thing as a completely free market; without some restrictions on individual behavior, a market will not exist. The question addressed and answered here is what kinds and how much restrictions there should be.

The conflict with the property rights approach is more apparent than real. In choosing a structure for the securities market, individuals are making a kind of social contract, which involves a specification of property rights. It is at this more fundamental level that property rights agreements would be said to be made among securities market agents. Rather than hypothesizing contracts for specific disclosures, the property rights bargain relates to the existence and legitimacy of the rule-making institution itself.

On this interpretation, the property right agreed to behind the veil of ignorance is two-fold: First, investors have a general right to be given reliable, non-deceptive information about the corporation. But, because of the conflicting interests of managers and investors, the power of managers, and the fact that the securities market operates in a dynamic environment, it is not reasonable that capital market agents would make explicit concrete contracts for specific financial disclosures, which could be changed only by re-contracting and paying compensation, as the agency analysis suggests. The ability of corporate managers to invent new forms of leases to evade disclosure is a good example of this. The hypothetical agency contract regarding financial disclosure is then a very general one, in which owners and managers agree within very broad limits as to the right of investors to be provided with reliable financial information. The stewardship concept derived from common law is explained by this.

The economic approach to law [e.g., Posner, 1977], including the agency literature (insofar as it mentions property rights), emphasizes the desirability of a complete ex ante specification of rights, with subsequent trading. But, in the case of financial information, it is being argued here that it is more desirable not to have a complete specification. Furthermore, no buying and selling of rights to information takes place.[28]

So, managers would agree to act in accordance with GAAP, whatever GAAP may be.[29] That is, the "agency" agreement is an agreement, once and for all, to abide by the decisions of a third party, rather than to a specific reporting format. Insofar as these techniques are locked in they can easily become less valuable. The only way to keep financial statements current (in a changing environment), and therefore responsive to changes in management behavior, on the agency approach, would be to re-negotiate the contract periodically. But how is that to be done? Gonedes, Dopuch and Penman's

[1976] suggestion of unlimited direct costless bargaining among all interested parties is clearly unrealistic.

Instead, rule-makers are to promulgate, and securities market agents act in accordance with, an open-ended set of principles or rules. This is more nearly what is found in practice, whenever changes in financial statements are made after the initial issuance of shares. It is manifested, e.g., in the New York Stock Exchanges' tightening-up of financial reporting of certain firms, and in the 1934 Securities Exchange Act, empowering the Securities and Exchange Commission to promulgate such "...rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." [Sec. 10(b) in Schwartz, 1973, p. 269] The SEC is thus to make those rules, including financial disclosure rules, obedience to which fulfills the "social contract." This is also the function of the FASB, in the agency context.

Then, the establishment of such a body (as well as obedience to it on the part of securities market agents) is a necessary part of the agency agreement. Gonedes, Dopuch and Penman [1976] point out that financial reporting policies are apparently feasible outcomes of direct bargaining between owner and managers, but are evidently not "spontaneously" agreed to. Thus, they say, the policies must generate some inefficiency. But this is too narrow a view. Instead, any inefficiency of this sort caused by a central rulemaker is simply one component of the total agency cost incurred. Thus, a central policymaking institution is itself Pareto-efficient. It is desirable, ceteris paribus, to minimize such costs, but, as Jensen and Meckling themselves point out [1976], it is unrealistic to compare the resulting state of affairs with the Pareto efficiency of a world without agency costs.

In any case, the conflicts of interest between owner and manager need to be settled somehow. A right may be defined as specifications of justifiable

interests; they are especially pertinent in situations in which individuals' interests conflict, for they help determine whose interest is to prevail.

Thus, the second part of the original agreement is to establish a rule-maker to adjudicate conflicts of interest, and in so doing, making the investors' general right to information either more specific, or else modifying it in some other way. The fact that, in 1981, a new financial reporting rule restricts a corporate manager's reporting options, and thus decreases his expected utility, is irrelevant. Such a rule is not an interference in the securities market, preventing Pareto-efficient outcomes. Instead, it is a part of the structure of the securities market itself, freely agreed to.

In summary, the proper role of the rule-making institution in the securities market is to determine the specific content of financial reports to owners. This has two parts, involving both efficiency and equity issues. One is to help the securities market meet the conditions of an ideal market by making securities of different firms a more homogeneous good, and by making information symmetric (homogeneous) among investors. However, if the goal of financial reporting policies were simply to yield such homogeneity, any level of information quality would do. Therefore, the second task of policymaking is to achieve the level of information quality which is most in the interest of securities market agents. In doing so, it decides what specific rights to information owners have in the current situation. The ability of managers to invent new kinds of leases (to escape disclosure) does not mean that owners should have to compensate managers for changes in disclosure practices. It does mean that the general right of owners has to be re-specified. But this is like a judicial decision (in the form of, e.g., FASB statements) to be made by an independent party, rather than via direct bargaining (which does not exist and is, indeed, hard to imagine). This shows why it is so important

that the FASB be (and appear to be) independent of special interests, and why the FASB should be concerned about it. It also shows the importance of the kind of research conducted by, e.g., Watts and Zimmerman [1979], to determine the degree to which the FASB is carrying out its responsibilities.

The equity issues discussed above arise out of the desire of securities market agents for efficiency. Thus, at least in this area, efficiency is not independent of all equity problems. Other justifications for the existence of a financial reporting rule-maker based on pure equity grounds could be developed; they were not attempted here because of the desire to provide a justification on grounds as close as possible to the ones accepted by those who are skeptical of the desirability of financial reporting rule-making.

Footnotes

1. I am confining the scope of the problem to the securities market, but not because I think that only the interests of securities-market agents are relevant to deciding whether to have a rule-maker. Rather, I want to limit the discussion to a specific kind of argument regarding the justifiability of such a rule-maker. The problem is complex enough without extending its scope.

2. I do not wish to deny that these analyses contribute to an understanding of the problems that arise once a system for corporate financial disclosure is chosen. Watts and Zimmerman [1979] and Sunder [1980] are especially pertinent.

3. See, e.g., Sen, 1970. A state of affairs x is Pareto-efficient if and only if it has no Pareto-superior; a state of affairs y is Pareto-superior to x if and only if y is superior to x for at least one individual, and x is superior to y for no individual.

4. For a more detailed criticism of this approach, see Beaver and Demski, 1974.

5. It has been commonly argued [e.g., Smith, 1937; Berle and Means, 1968; Donaldson, 1963] that there is a divergence in the interests of owners and managers, that can be manifested in various ways. Monsen and Downs [1965], unlike the others, emphasize the role of information in the relationship between owner and manager. According to them, two conditions are necessary for managers to increase their own income at the expense of the firm's efficiency: (1) that acts are in their own interests, and (2) that "it is impossible or very difficult for their superiors to discover these acts." [1965, p. 228] That implies that one of top management's key strategies is "carefully screening all information which is forwarded to stockholders or the public at large." [ibid., p. 232] Just because management does have a great deal of control over the firm's financial information, it is hard to obtain strong evidence as to whether management does use financial reporting in this strategic manner, to favourably affect outsiders' beliefs concerning the firm's performance. [Salamon and Smith, 1979, p. 320] However, some evidence does exist. Smith [1976] found evidence consistent with the hypothesis that managerial firms were more likely to employ accounting policy decisions to smooth the income stream. Kryzanowski [1978] found that managers were able to conceal information from stockholders, thereby manipulating security prices. One technique for doing so is "manipulation of the generation and release of (mis)information on company activity." [ibid., p. 368] Salamon and Smith concluded that managerial firms exercise control over the information in annual reports "in a manner which may misrepresent firm performance."

6. As has often been recognized, financial information is a public good. [E.g., Gonedes and Dopuch, 1974; Beaver and Demski, 1974]. A public good has two characteristics. One is tht there are indivisibilities of production or jointness of supply. That means that there are economies of scale, such that once one individual (or coalition of individuals) has paid for its production, the marginal cost of supplying it to others is zero or nearly zero. The second is that once the good has been supplied to some individuals, it is inefficient, if not impossible, to exclude

other individuals from consuming it. The import of non-excludability is that purchasers of information are not able fully to appropriate the benefits of the good. The result is the so-called free rider problem: since non-purchasers cannot be excluded, they also cannot be forced to pay for their use of the public good.

7. It is not clear how large bargaining costs would be; but it should be clear that they would be substantial. The number of agents (M) in the market is a crucial parameter. For, as M increases, the marginal cost of both coordination and information increases, to the point that a bargaining approach to attaining a Pareto-efficient allocation is impractical. [Riker and Ordeshook, 1973, p. 254] The large numbers case should be the focus of the market analysis for two reasons. First, in any real information market, M would be large. Second, the market analysis is based on the idea that all markets are competitive; this requires that there be a large number of price-taking market agents. There is thus no comfort in observing that the problems to be discussed below are either nonexistent or (relatively) insignificant in the small-numbers case. [Baumol and Oates, 1975, p. 10; Head, 1974, p. 84-85] Gonedes' analysis implicitly assumes that information market agents bargain in good faith. Bad faith may take either of two forms, both involving the non-excludability of public goods. First, agents have an incentive to renege on the agreements made. One obvious way would be for an information purchaser to back out of the purchasing coalition (refusing to pay his or her share) once an agreement is made. Since financial information is a public good, the reneging party becomes a free rider. Another form of reneging would involve the information producer. Presumably information disclosure contracts would require that information production agreements include a stipulation regarding the reliability of the information. But, insofar as the provision of more reliable information would be more costly to the information producer, he or she has an additional incentive to produce less reliable information than is specified by the coalition agreement. That is, information producers have an incentive to deceive information users. Furthermore, this will be more successful as the reneging is more difficult to detect. A second form of bad faith bargaining can arise through the preference revelation problems regarding public goods. [E.g., Mueller, 1979, p. 25f; 78-83; Head, 1974, pp. 83-86] Information market agents have an incentive to misrepresent their demand for financial information. they would thus be free-riders to the extent that, by so doing, they would successfully shift the cost of information production to other members of the coalition. The result is failure to attain Pareto efficiency. [Head, 1974, p. 84]

8. Even here, Aivazian and Callen (1979) have shown that the Coase Theorem does not hold unconditionally, when there are more than two economic agents: there are situations which ahve no stable equilibrium, a cycling a la the Voter's Paradox. Thus under Coase's conditions a centralized, non-market solution may be appropriate.

9. Fama [1980] makes the point that debt and shareholder investment are merely alternative sources of financing with various advantages and disadvantages, a view going back at least to Paton [1922, Ch. 2] He then goes on to say that the stewardship principle, in the form of control by owners over the actions of entrepreneurs, is not important in the context of securities markets. But in the domain of financial reporting, this is

not the case. The information needs of parties outside the firm who lack the power to obtain relevant information--an idea again going back at least to Paton and continuing up the present [FASB, 1980]--and the responsibility of managers to provide that information are of primary importance. This holds holds regardless of the specific characteristics of the financing instruments themselves.

10. This is consistent with the rationale for rejecting the market value rule. It is also consistent with the so-called "public interest theory" or regulation, according to which regulators do choose, or (alterntively) ought to act in such a way that the set of regulations chosen are more in the collective interest of the group than are alternative sets of regulations. According to the public interest view, regulators act in their own self-interest by acting in the collective interest. This is rejected in favor of the view that regulators act in their own interest by acting in the private interest of the most powerful ("special interest") group trying to influence the content of regulations. The most powerful group is presumably able to give the highest rewards to the regulators. Any mention of the public interest on the regulator's part, or the provision by them of a rationale for choice, is simply a subterfuge -- "a useful weapon in the political arena" [Watts and Zimmerman, 1979, p. 288] -- to cloud the real reasons for choice (i.e., private benefit to a regulator). Outright bribery of public officials is limited only by the difficulty of enforcing the agreement [Watts and Zimmerman, 1979, p. 285, fn. 41].

11. There are three sufficient conditions for an efficient property rights system. [Hirsch, 1979, p. 14; Posner, 1977, Ch. 3] First, it must be universal, in the sense that rights can be exhaustively specified and are each assigned to someone. Second, ownership of property rights is exclusive. That is, property is private property; exclusion of non-owners is feasible (and will be enforced by law). Third, property rights are freely transferable, without restrictions. If the parties to a property transaction can reach a mutually satisfactory agreement, no obstacle is imposed.

12. Members of the so-called "Rochester School of Accounting" [Jensen, 1976] (e.g., Jensen [1976] and Watts and Zimmerman [1979]) seek an explanation of the institution's actual workings in politico-economic terms, according to which the rule-making apparatus is an instrument of coercion, controlled by those groups with greater political or economic power. As such, the rule-making system is an imposition on and interference in the workings of the securities markets, and benefitting those who are able to control it. At the same time, it is clear that at least some of them have a normative purpose behind their research. For example, Jensen claims that the positive results "imply policy prescriptions." [1976, p. 13, my emphasis.] He goes on to call for more research in accounting, in order that the institutional structure of financial reporting will "shift in a desired direction." [ibid.] He subscribes to a theory of regulation, according to which "politicians, bureaucrats, and special interest groups are using the notion of social responsibility and the power of the political sector to effect wealth transfers from corporate owners, creditors, and the consumers of the corporation's products to others in society." [ibid., p. 17; see also Watts and Zimmerman, 1979, p. 275] Furthermore, it is clear from the context that he regards this as undesirable: the government is

confiscating wealth by coercion. Apparently, given that this is more or less inevitable, interested parties should learn how to control the institution for their own advantage. [ibid., p. 13]

13. The difficulty of determining what outcome would have been produced by a market will not be pursued. Nor will any issues presented by the possibility that the class of Pareto-efficient outcomes is not singular.

14. Apparently, this would mean assigning the rights to the information generated by a corporation to its managers, since assignment to investors would not produce a market between investors and managers. (The difficulty of excluding non-purchasers would preclude a market between actual investors and potential investors.) Then, investors and non-investors could bargain with each other and with managers, and form coalitions for the production and dissemination of information. The successful coalition would purchase the property right to information specified in a contract, and perhaps limited in time like a lease (even though the common stockholders investment contract is not limited in time). If additional, or different, information were desired, it would be obtained by re-contracting with whomever currently owns the property right, or by a new contract with the managers. In any case, a large number of overlapping contracts would exist in all probability -- there is no reason to expect a "general purpose" financial statement to evolve, even for a single corporation.

15. "U.S. Steel's Bracy Smith argues that it was impossible for U.S. Steel to stand alone against the crowd unless it was willing to see its stock suffer. 'We would be very happy if they would make the rule that everyone has to take accelerated depreciation on their books... But you can't have just one company doing it.'" (Minard and Wilson, 1980, p. 97) But, such an equilibrium may not be optimal, because (see, e.g., Mueller, 1979; Luce and Raiffa, 1957) of the Prisoners'-Dilemma characteristics of collective choice issues. Here, members of the steel industry would be the players of the Prisoners' Dilemma.

16. The concern here is with of a specific social institution, the securities markets as found in, e.g., the United States, Canada, and the United Kingdom, rather than with the basic structure of society. Indeed, the fact that many highly developed countries lack extensive securities markets shows that no general claims about the justifiability of basic social orders are being made.

17. A Pareto-efficient allocation of resources will result (i.e., be in equilibrium) under the following conditions: (a) There is perfect competition; (b) there are no external effects in consumption or production; (c) no consumer is satiated; and, (d) second-order conditions are satisfied for each consumer and producer. [Henderson and Quandt, 1971, p. 256; Gauthier, 1978, pp. 77-79] In short, a unanimously preferred outcome will result from the interactions of individuals acting independently in their own interests.

18. Managers historically have had an obligation to provide information to investors, both in "common law" (via the stewardship principle) and in corporate law.

19. Managers of other firms are in competition in either input (including capital) or output markets.

20. Thus, Atkinson and Feltham's assumption that management provides completely reliable information to investors and, at the same time, rejecting the market value rule is highly questionable.

21. For a more complete treatment of deception in corporate financial reporting, see Gaa and Smith, 1980.

22. Because of its past use, it might be thought that the present argument is an ethical one, and as such goes far beyond the bound of conventional economic frameworks. In a sense, this is true. But the argument is made on narrow grounds, matching the suppositions of the economic framework, and therefore provides an economic rationale, whose lack Gonedes notes. Thus, for example, it is assumed here without argument that securities markets are effective and equitable methods of allocating financial resources to real production. It will be argued that a desideratum for markets of all kinds is that there is no systematic bias against any class of market agents to make free transactions on an equal foooting with all other agents. This is a kind of symmetry condition, barring, e.g., deception, fraud, and coercion. These claims are ethical, to be sure; however, they should not be objectionable to economic analysts. But the argument is not an ethical one, in the sense that it is an application of, e.g., some particular theory of justice, to the problems of financial reporting. Rather, it seeks to show why a securities market agent--conceived as a rational decision maker attempting to pursue a rational plan of life [cf. Rawls, 1971]--would want a rule-maker. Thus, for example, the impact of financial reporting on society in general--through its effect on real production an on the wealth of members of society who are not securities market agents--is ignored. [See, e.g., Anderson and Meyers, 1975]

23. Furthermore, the empirical issue may never be <u>adequately</u> settled. The question of whether a rule maker minimizes the cost of securities market transcations, though empirical, may not actually be susceptible of a reliable answer, in view of the difficulty of doing research on it. Note that an empirical question is one which is <u>in principle</u> settleable using empirical techniques. [Hempel, 1965] Among other things, this means that Benston and Krasney's [1978] claim that the burden of proof is on advocates of rules-making to show that rules have social value is not as telling as it might appear.

24. At a general level, the "market for lemons" literature has resulted in some understanding of product quality uncertainty. At a more specific level, even less has been done in the academic accounting literature. However, information quality has been accorded much attention in the professional literature. Accounting Principles Board Statement No. 4 [1970], the American Institute of Certified Public Accountants' <u>Objectives of Financial Statements</u> [1973], and the FASB's <u>Statement of Financial Accounting Concepts No. 2</u> [1980] are only the most prominent recent examples of the profession's efforts to come to grips with the concept of information quality.

25. For example, according to the AICPA's study group on objectives, "the qualitative characteristics of financial statements [i.e., the

information contained in financial statements]... should be based largely upon the needs of users of the statements. Information is useless unless it is relevant and material to a user's decision. Information should be as free as possible from any biases of the preparer. In making decisions, users should not only understand the information presented, but also should be able to assess its reliability and compare it with information about alternative opportunities and previous experience." [1973, p. 60]

26. It might be argued that the third parameter is unnecessary because perceived information quality would be impounded in securities prices by affecting the perceived risk and return characteristics of securities, and furthermore, that much of the effect can be diversified away to be true. This is in part an empirical question; how to test it is less than obvious. Furthermore, the theoretical basis for the claim assumes an ideal securities market, including zero transaction costs. So, a rule-maker cannot be dispensed with, on this ground, even in theory, since (as argued above) the role of a rule-maker is to make the market more nearly ideal in the first place. Furthermore, that aggregate information quality is a public good is enough to show tht compacency is not appropriate. In any case, all the claim amounts to is that securities market agents are able to adapt to their environment whatever it is, good or bad. Lack of attention to this third parameter in security market research can be explained by observing that one of the purposes of central policymaking is to make the level of information quality more homogeneous among firms, thus presumably making it less important as a predictor of, e.g., security price differentials or reactions. Furthermore, how to operationalize it as a variable is unclear.

27. It fits the Prisoner's Dilemma analysis: (1) one cannot be excluded from participating in the securities market, and thus cannot be excluded from consuming the average quality of the goods (securities) in making investment decisions; and (2) the tendency of the average quality to drop is a direct result of the incentive of sellers (i.e., management) to act as free riders. Furthermore, unilateral action to increase average quality by increasing the quality of an individual firm's securities (by increasing the quality of information about it) are unlikely since "the rewards... tend to accrue to the grop as a whole -- in raising its average quality --rather than to the individual." [Akerlof, 1970, p. 495] That is, the individual manager acting as an individual cannot appropriate all the benefits of his actions.

28. Again, the argument bars neither secondary markets for information nor voluntary disclosure by management of additional information (which could raise the quality of information about the firm above the minimum standard). Rather, it is argued that at least some disclosure practices are not subject to direct negotiation between investors and managers.

29. And to be audited with respect to their actions [Ng, 1978].

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