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Book Reviews

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Two copies of books for review should be sent to the incoming Book Review Editor: Professor Gary C. Biddle, Room 1305, K. K. Leung Building, The University of Hong Kong, Pokfulam, Hong Kong. The policy of *The Accounting Review* is to publish only those reviews solicited by the Book Review Editor. Unsolicited reviews will not be accepted.

ICAEW FINANCIAL REPORTING FACULTY, *Financial Reporting Disclosures: Market and Regulatory Failures* (London, U.K.: ICAEW Financial Reporting Faculty, 2013, ISBN 978-0-85760-296-1, pp. ix, 79).

The stated objective of the Institute of Chartered Accountants in England and Wales (ICAEW) in this monograph is to examine "sources of unhappiness" about "widespread complaints of information overload in financial reporting" and "identify a number of ways in which the regulatory framework should be changed to address current concerns" (p. vi). I begin with a brief summary of the book. The monograph consists of six chapters along with four appendices that summarize more technical material such as details of research studies cited and disclosure frameworks proposed by the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC), and other regulatory bodies. The six chapters are organized as follows. Chapter 1 introduces the concept of disclosure overload as "too much information," because it is common for companies to produce annual reports far in excess of 100 pages. It goes on to frame this debate in the context of (1) the information explosion that we have witnessed in general with the advent of the Internet; (2) a rising expectation in society about transparent reporting in many areas (e.g., information about pharmaceuticals to consumers); and (3) the incentives of the stakeholders associated with corporate financial reporting (e.g., auditors, standard setters, lawyers, competitors, managers, and politicians).

Chapter 2 suggests that firms have incentives to provide financial disclosures to outsiders and that disclosure overload might have occurred in any case even in the absence of mandatory disclosure regulation, given the advances in technology and expectations about transparency. Chapter 3 summarizes the classic arguments for market failures associated with the production of financial information and how regulation addresses these market failures. For instance, it is often argued that disclosure is a public good that is consumed by users who do not necessarily pay for it. Hence, voluntary disclosure will be under-produced, in the absence of regulation. Chapter 4 recognizes that regulation potentially creates incentives for firms to game the rules and for regulators to serve their own ends. Chapter 5 discusses regulatory failures, the more important of which impose uniform reporting requirements on diverse firms to meet the needs of inherently diverse users. Such regulatory failures, in turn, potentially lead to disclosure overload. Chapter 6 discusses what should be done to address these problems and potentially reduce disclosure overload.

Overall, I enjoyed reading the monograph and found it to be even-handed and a great reference for questions that are often raised about why financial disclosure is mandated. I organize the review of the monograph around four issues: (1) the importance of the question examined; (2) does mandatory disclosure improve outcomes; (3) the novelty of the material presented; and (4) a critique of the recommendations proposed by the monograph.

IMPORTANCE OF THE QUESTION EXAMINED

It is not obvious to me that the complaint of "disclosure overload" is a legitimate and a credible concern among the stakeholders associated with financial reporting. Although the monograph is often at pains to point out that it is meant for an international audience, I cannot help but think about the U.S. context because of (1) my background, and (2) some of the best data to evaluate claims of disclosure overload are available in the U.S.

At least in the U.S., potentially excessive disclosure stems from the existing institutional arrangements, which are difficult to alter in the short run and perhaps even in the long run. Much of the disclosure is boilerplate in nature and is excessively detailed to ward off the threat of a class action lawsuit. Assuming that the existing legal system is difficult to change, self-interested firms are perhaps better off providing excessive disclosure even if such actions reduce the probability of a lawsuit only to a small degree. Sophisticated users always have the option to ignore disclosures they might perceive as unnecessary or unreliable. For instance, there is evidence that creditors have begun under-emphasizing the role of the balance sheet, which has become increasingly fair-value oriented on account of FASB pronouncements, in writing debt covenants (Demerjian 2011). Unsophisticated investors are perhaps better off holding mutual funds that mimic the market or particular sectors of the economy and, hence, do not have to worry as much about excessive financial reporting disclosures. Standard setters have little incentive to write a standard saying that their job is done. As a chief financial officer once remarked to me, "[T]he FASB could have stopped after writing the conceptual framework" (Dichev, Graham, Harvey, and Rajgopal 2013). Auditors benefit from complex regulation as the market for their advisory services expands (e.g., fair-valuing intangible assets in a business combination or evaluating whether an asset is impaired relative to the fair value of the asset). In sum, there is not much incentive for existing stakeholders to address the issue of "disclosure overload," even if it were a first-order problem.

DOES MANDATORY DISCLOSURE IMPROVE OUTCOMES?

The question of disclosure overload is relevant only if we believe that mandatory disclosure adds value. The monograph claims that "there is abundant research evidence of the benefits of disclosure (which we discuss in Appendix 3)" (p. 3). I am not as convinced as the ICAEW of the benefits of mandatory disclosure.

Before proceeding, it seems useful to ask whether scholars have been able to identify a serious, systemic information-related problem that mandatory regulation can correct. I could not find such evidence in the monograph. This is not to argue that we cannot find instances where firms have harmed stakeholders by exploiting private financial information. However, it is not obvious that mandatory standard setting has successfully mitigated this problem.

One of the key benefits cited is the purported link between mandatory disclosure and lower cost of capital. Several of these cited studies do not seem to discuss why firms would leave money on the table and not disclose financial information voluntarily, if such behavior materially reduces cost of capital. In my interactions with practitioners, I have found that they often talk about a potential link between disclosure and share prices, not about cost of capital. As is well known, decoupling the impact of future cash flows from cost of capital effects in share price is a difficult, if not an impossible, task. I wonder whether the early work on the potential link between disclosure and cost of capital has become a convenient excuse for regulators and standard setters to justify their mandate to continue writing disclosure regulations.

It is not obvious that mandatory disclosure improves outcomes for investors in other settings that have mandated more financial disclosure such as the SEC's 1933 Truth-in-Securities Act (Stigler 1964; Benston 1973; Jarrell 1981). Greenstone, Oyer, and Vissing-Jorgensen (2006) found that shareholders valued the 1964 Securities Act Amendments that extended mandatory disclosure regulations to large firms traded over the counter, but the authors cautioned that they could not comment on welfare gains, as shareholder gains might be offset by managers' losses. Ferrell (2003), however, reported that a simple comparison of stock returns in the years before and after the 1964 Act was implemented showed no increase in stock returns. Gomes, Gorton, and Madureira (2007) found that Regulation Fair Disclosure had the unintended consequence of causing a welfare loss to small firms because they faced a higher cost of capital. Coates and Srinivasan (2014) find similar mixed evidence in their survey of the literature on the impact of the Sarbanes-Oxley Act of 2002. Somewhat surprisingly, none of these studies is cited in the monograph.

Finally, it is not obvious that the mandatory disclosure of information has improved social outcomes in other settings such as patient safety, plant closing disclosure, nutritional labeling, toxic releases disclosure, and workplace hazards disclosure (Fung, Graham, and Weil 2008), and even in areas that are claimed as a policy success in mandatory disclosure such as mortgage lending disclosure and restaurant hygiene disclosure (Winston 2006).

NOVELTY OF THE MATERIAL PRESENTED

Much of the material reviewed in the first three chapters of the monograph can be found in existing academic literature surveys, research articles, and books. To summarize, Chapter 1 claims that no market or regulatory forces can fully address the impact of three factors on reporting: (1) subjective judgments of preparers, (2) managers' "self-reporting bias," and (3) firms' proprietary costs. Chapter 2 argues that disclosure overload could occur even in the absence of regulation due to changes in the nature of markets, product, and capital, and in technology. Chapter 3 suggests three types of "market failure" that might motivate a role for regulation in reporting: (1) reporting is a public good and will, hence, lead to under-production of such information, (2) mandatory standardization can enhance comparability of disclosures, and (3) regulatory regimes are likely to make disclosures more reliable and credible.

The role of agency costs, proprietary costs, and the use of managerial discretion in financial reporting, discussed in Chapter 1 here, has been extensively researched (see Fields, Lys, and Vincent [2001] and Beyer, Cohen, Lys, and Walther [2010] for literature reviews). Watts and Zimmerman (1986) discuss the characterization of market failure in the market for disclosure and the potential role for standardization (the material covered in Chapter 3 in the monograph). Similar to Chapter 5 in the monograph, preparers' distaste for the reporting requirements imposed by the FASB has been covered extensively in Dichev et al. (2013).

CRITIQUE OF THE RECOMMENDATIONS

The recommendations made in the monograph in Chapter 6 raise some obvious and thorny questions. The overarching concern is whether a regulatory body such as the ICAEW can even be objective about questions related to whether regulation in disclosure is effective. Most of the recommendations made in the monograph assume that the regulator can somehow efficiently adjudicate between competing interest groups in a socially optimal manner.

One of the specific recommendations of the ICAEW is that standard setters should assign more weight to the views of equity holders, the owners, who meet the cost of disclosure requirements. How exactly should they do that? Who exactly are these mythical owners? Most of the larger shareholders, such as institutional investors, already lobby the FASB and influence disclosure requirements. Do we have evidence to suggest that the FASB under-weights the input of such shareholders? These recommendations are particularly puzzling, because the ICAEW recognizes the difficulty in identifying the so-called "mythical user" (Young 2006) on page 5, but it continues to succumb to the same fallacy when it makes its own recommendations.

Another recommendation by the ICAEW suggests that standard setters should establish a framework to ensure that disclosures are required only when they are needed and that standard setters should regularly review the rules to weed out excessive disclosure. I doubt whether any standard setter would admit to requiring firms to make excessive disclosure. In their minds, all the disclosure requirements they approve add value. And, can we trust standard setters to correct their past mistakes, given that past standards have potentially caused the disclosure overload problem in the first place?

A recommendation, along similar lines, suggests that enforcement agencies and auditors should clarify that they will not take action against firms that omit immaterial disclosures. Do we have evidence to suggest that the SEC overzealously penalizes firms for omitting immaterial disclosures? The bigger concern is that their enforcement of even material disclosure and reporting issues is hobbled by resource constraints (Kedia and Rajgopal 2011) or potential regulatory capture (Correia 2014; DeHann, Kedia, Koh, and Rajgopal 2014).

Finally, the ICAEW recommends that preparers and users should engage directly to discuss voluntary disclosure rather than rely on standard setters to introduce new disclosure requirements. This recommendation again begs the question of (1) who is the "user," and (2) why do we need a standard-setting body in the first place if users and preparers could indeed coordinate disclosure concerns on their own?

An often overlooked issue with these recommendations is that regulators or standard setters have to adjudicate on wealth transfers across several interest groups and, usually, the more powerful interest group wins. This political reality on these recommendations makes me wonder whether the ICAEW's recommendations have any real bite.

In conclusion, the monograph is an interesting read, but I walked away unconvinced that disclosure overload is a first-order concern that we can do anything about.

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