

CORPORATE GOVERNANCE AND FINANCIAL REPORTING

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1. Introduction

This paper examines the link between financial reporting and corporate governance. Based on empirical examples of the recent confidence crisis in financial reporting and within an information economics framework, the fundamental case is being established. Then, the core elements of financial reporting are being presented. Based on an analysis of various international accounting standards frameworks, the demands financial reporting has to meet from a corporate governance-perspective are identified. A review of cases and literature reveals challenges which remain.

2. The Case for Corporate Governance and Financial Reporting

2.1. Accounting Scandals: Rebuilding Trust in the Financial System

Corporate governance broadly can be defined as the set of processes, policies, laws and institutions affecting the way a company is directed. It also includes relationships among the stakeholders of the company and a definition of the goals for which it is governed (OECD, 2004; Cadbury Committee, 1992; Economiesuisse, 2002). In the early days, most attention focused on rules and policies to share power between principals and agents and govern management activities (see chapter 2.2).

Within the past few years, it has become evident that financial reporting is a core element of corporate governance. Without transparent, relevant, reliable information, a company's stakeholders are not able to assess management performance, and to make the investment decisions they need to make. The sudden demise of large, well-established companies such as Enron,¹ WorldCom¹ or Parmalat¹ as well as significant financial reporting restatements at Shell,¹ Xerox,¹ Ahold¹ and many others have shaken not only confidence in financial reporting, but into the financial system as a whole. As a consequence, stock markets have been lousing for several years,¹ and pension systems worldwide have been under

pressure.¹ Financial Reporting today is perceived no longer as a low-priority bookkeeping exercise, but a central function for directing a company under good corporate governance principles.

2.2. Information Economics: Healing Information Asymmetry with Financial Reporting

From a traditional perspective the object of financial statements is to provide information about a company's economic situation that is useful for a wide range of users for economic decision making and observing management's quality.¹ This decision oriented objective of financial reporting is the constituent part of the various national accounting systems. Investors need information about the amounts, timing, and uncertainty of the company's future economic inflows and outflows.

Generally speaking information is needed for two purposes: From an economic point of view financial reporting is one important and reliable source of information that helps to allocate capital more efficiently. Misleading information might channel funds into inefficient companies. Capital markets may even collapse when those who normally make business and economic decisions feel that they do not get enough or biased information. Financial reporting reduces information asymmetry between company insiders (i.e. the management) and outsiders (i.e. investors).¹ Not only is the capital market affected by financial reporting. The market performance of a company also influences the financial reporting data e.g. when management compensation plans are stock-based.¹

Second and in a more legal sense investors shall be protected by information. Misleading information does not only channel the capital into inefficient companies. Those who are responsible for the financial reporting are also threatened with legal consequences.¹

The less outside investors are informed the less they are able to protect themselves by making useful economic decisions. It is obvious that an effective corporate governance system requires an effective information system and for this reason there is also a

need for an effective financial reporting system (Baker and Wallage, 2000). Brief and come to the point: „Financial reporting is a key aspect of corporate governance...” (McBarnett and Whelan, 1999).

3. Elements of Financial Reporting

Under IFRS and US-GAAP the financial statements of listed companies comprise of numerous elements, at least a balance sheet, income statement, statement of changes in stockholder's equity, cash flow statement, information about accounting policies and additional notes (IFRS Framework 1; SFAC para. 13). IASB, FASB and other national standard-setter promote a seemingly obvious but also very ambitious objective for financial statements: The financial position, financial performance and cash flows of a company shall be presented fairly so that the users of those statements can preserve their interests by making useful economic decisions (IFRS Framework F.12; IAS 1.13).

Keeping in mind accounting scandals in recent years one can come to the conclusion that the accounting information presented by financial statements did not match the needs of the shareholder and other stakeholders. This is not only because of “creative” accounting techniques and management's illegal accounting practices but also a consequence of the expectation gap. The expectation gap describes the difference between the information quality and usefulness of financial statements expected by shareholder and stakeholder and the information the accountants (and auditors) feel responsible for. As Walker stated: “In its simplest form, the expectation gap argument reflects the fact that accounting reports do not always reflect present market values – although many think they do.” (Walker, 1991, p. 60).¹ And so as a matter of fact there is a lag of understanding within the public about the limitations of financial statements and the audit function.

It is not surprising that the user's ex ante perspective about future company value and performance derived from financial statements compared to the ex post outcome of their decisions do vary considerably. The core elements of financial statements are typically based on the accounting records of a company and are for this reason mostly quantitative and based on past events. But for decision making shareholder and other stakeholders need to have more profound information about the present and the expected future rather than the past economic situation of a company. Unfortunately there is a trade-off between relevant forward-looking information (e.g. predictive and so-called fair value) and reliable backward-looking information (e.g. historical cost).

Increasing the quality of users economic decisions is not only a question of impeding fraudulent misrepresentation by legal and oversight actions but also a question of enhancing financial statement information quality (see section 4 for

details). Just communicating financial statements is not enough to fulfill investors' needs. Their decision making process is not only based on accounting system numbers. It is indispensable to supplement the quantitative financial data with narrative information about the main factors that might influence companies future financial development. Seeing the necessity of additional information because “financial statements are not sufficient to meet the objectives of financial reporting” the IASB published the discussion paper “Management Commentary” at the end of 2005 (IASB, 2005a). What can be observed now is a growing understanding that today's elements of the financial statement do not contain appropriate and sufficient information to satisfy the users' demand. So the elements of the financial statement are within themselves only an element of the broader financial reporting hierarchy and financial reporting must be embedded in the whole corporate communication strategy.

4. Financial Reporting Challenges

4.1. True and Fair View

The main objective of financial reporting is the conveyance of a true and fair view on the economic situation of a company to the users of financial statements (see chapter 3 above). This requirement, however, is not always easy to meet. Reality often proves to be too complex for being adequately captured by a set of accounting standards and regulations.

A first significant limitation in expressing the true economic situation of a company in a set of financial statements is a widespread disregard of the intangible assets of a business. Values such as trademarks, employee workforce or company goodwill might well be significant, but are excluded of most standards for financial reporting worldwide.¹ The reasons given by standard-setters usually focus on the technical problems in assigning a reliable value or a frequent inability of a company to demonstrate sufficient control over the assets. As business models in today's economy more and more incorporate intangibles into their value creating function, the impact of intangibles increases. Investors therefore have to include even non-reported intangible assets somehow into their considerations. As a consequence, the risk associated with assessing the economic situation of a company increases, and there is an increasing gap between book values and company values (see

Figure 1).

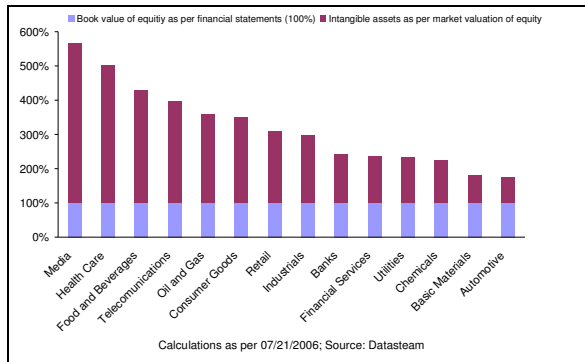


Figure 1. Accounting and market values

The second major limitations in expressing a true and fair view are difficulties in determining reliable values of assets and liabilities. Standard-setters more and more require assets and liabilities being stated at "Fair Value",¹ which is usually defined as the value arising from a transaction between independent parties on a more or less efficient market.¹ As many financial statement items include non-standard positions, determining such a fair value often is almost impossible, and incorporates significant uncertainties into financial reporting.¹

A third major limitation is of a more structural nature: Accounting standards worldwide are either principle-based or rule-based.¹ In a principle-based system, only general requirements are given, with a significant amount of professional judgement required from preparers and auditors in adequately applying the framework to the individual case. Under a rule-based regime, standard-setters aim to capture each and every possible outcome of reality in a specific regulation, with no latitude in applying the standards. As in practice financial reporting is driven individual interests, both systems prove to be too simple to capture a complex reality: Under a principle-based system, preparers willing to lure investors to buy their stock will argue "show me where it says I can not do it this way" (Carlino, 2004, p. 6), while reporting in an overly aggressive way. Under rule-based system, however, the existence of an exact rule not only determines what has to be done, but also very reliably gives an indication of how to circumvent it.¹

4.2. Organisational Limitations

While financial reporting information is becoming increasingly important for management purposes (Jermakowicz and Gornik-Tomaszewski, 2005, p. 52), in most cases, top management does not view financial reporting as being one of the main value creating functions of the enterprise. As a consequence, the resources dedicated to financial reporting are frequently scarce, and the resulting processes in need of improvement.

This general problem in the past few years has been aggravated by the increasing speed of business, in particular a constant stream of mergers, acquisitions and divestments. Each transaction puts great pressure on the finance organisation, as new processes have to be implemented and changes need to be made to current EDP systems. The pace-of-change-problem even has been increased by the standard-setters themselves, with numerous new regulations being published within short periods of time.¹

4.3. The User Problem

Financial reporting involves both sender and receiver of information. Frequently, problems in determining the true and fair economic situation of a company rest not with the preparer or the auditor of financial information, but with the investor or his advisor: With the increasing complexity of the financial world and accounting standards, reports have become lengthy and difficult to analyse.¹ Again and again, the impact of new accounting standards has to be taken care of.¹ At the same time, resources in the financial sector have been cut down, and processes in financial analysis are more and more standardised.¹ As a result, the investment in knowledge and time required to determine the true and fair economic situation may not always be made.

5. Conclusion

Improving financial reporting is a key issue to strengthen corporate governance and control. Accounting scandals in recent years have shown that the information provided by today's financial reporting system is not as useful for decision making as it should be. The limitations of financial reporting are various and include for example the recognition problem of intangible assets and the measurement of assets and liabilities at fair value. Corporate governance and financial reporting can be understood as an information gathering system that involves both management and the recipients of those information outside the company. This makes it obvious that enhancing corporate governance is not only a problem of rulemaking and legal sanctions but also one of financial knowledge. Closing the expectation gap requires a better understanding of financial reporting and more assigned resources to analyze it. Unfortunately in many cases exactly the opposite can be observed.

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