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Standardization of financial information as a factor decreasing market risk

Abstract

The article pertains to the availability and reliability of financial information. The author suggests a thesis that the standardization of financial information is a necessary condition for limiting market risk. In the first part of the article, the author refers to macroeconomic consequences of erroneous investment decisions and to insider trading, a common phenomenon in contemporary economy. In the latter part, the author discusses systemic regulations for financial information and the desirable quality features which financial information should have.

Keywords: investment decisions, characteristic of accounting information, financial accounting standards.
JEL Classification: M48.

Introduction

Already in the middle of the previous century two acknowledged economists, J.A. Mirrless and R.E. Lucas, noted in their works that business entities operate in the conditions of imperfect information and are faced with the high costs of obtaining it. They called this phenomenon the information asymmetry. It leads to erroneous risk assessment in market transactions and to ineffective capital allocation. Currently, a new form of information asymmetry has emerged. Its premises include globalization and transactions in derivatives. The paradox of the New Economy is that thanks to the Internet and cell phones, information is commonly accessible, but the same is not true for financial information. Firstly, it results from the fact that financial information is a "product" of various accounting systems; secondly, because it is the object of diverse accounting manipulations; and thirdly, because it is appropriated by some of the executive staff for their own economic goals.

1. Macroeconomic consequences of erroneous investment decisions

The development of the financial markets and the liberalization of capital flows made financial information a quasi-market good. For the entity in possession of the information this situation is related to economic benefits. The phenomenon of information advantage in market situations has been known already in the past. However, it was only the world financial crisis of 2008-2009 that proved that information advantage is not the problem of a single investor or company. It is a feature of many developed countries, and even the world market as a whole. According to EUROSTAT, a drop in the real GDP in the years 2008/2009 amounted to 4.2% in the European Union (EU-15) and 2.4% in the United States. In Germany and Italy the GDP fell by 5.0%, in Great Britain by 4.9% and in the Netherlands by 4.0% (EUROSTAT 2009, 2010).

A decrease in GDP results in a loss of a part of fiscal revenues which has an adverse influence on the budgetary deficit and public debt. It is a result of erroneous investment decisions, the consequences of which are transferred not only to the economies of respective countries but also to the global economy. As G. Soros states in his latest book, this situation is aided by the globalization of the financial markets, where capital is subject to free transfers (Soros, 2010, p. 132).

A characteristic feature of contemporary economy is the unprecedented growth in turnover on the global financial markets. P. Samuelson, the doyen of economists, notes that it is similar to the snowball effect; the snowball is covered with further and further layers of money, until someone decides to verify its true value. It is estimated that the value of daily transactions on the global financial market reached USD 1.8 trillion in 2008, only 5% of which was the consequence of real movement of goods and services (Gruszecki, 2009, p. 2). It is the result of swift development of financial institutions as well as changes in the structure of assets of non-financial enterprises. This phenomenon may pertain to the most developed economies, but in Poland the changes are also clearly visible. In 2002, total assets of financial institutions amounted to PLN 584 billion, while in 2009 already PLN 1,492.1 billion. This means an increase by 2.5 times. The share of financial assets is also growing in the asset structure of non-financial companies. Long-term financial assets and short-term financial assets amounted in 2002 to 13.7% of total assets held by companies; in 2009 they reached the level of 21.4%[1].

Together with the appearance of ever more complex financial instruments their relation to real assets is decreasing. A case in point may be the transactions in structured derivatives. It is difficult to establish

[1] Data of the Central Statistical Office and National Bank of Poland.

what underlying instrument is the security for the transaction and how it was valuated. Manipulating financial information in order to achieve a higher-than-ordinary rate of return is rendered easier in these circumstances. What I mean here is both phoney accounting and purposeful non-disclosure of certain information.

A spectacular international-scale example of my argument would be the operation of Investment Securities LCC, created and managed by B.L. Madoff. Through manipulating financial information, Madoff created an illusion of good standing of his company and thus acquired new investors. When some of them wanted to withdraw their funds (in December 2008), it proved impossible. Financial information, on the basis of which capital was invested, proved untrustworthy. Investors' losses were then estimated at over 50 billion dollars. What is interesting, there were also institutional investors among them, such as: Fairfield Greenwich Advisors (USD 7.5 billion losses) or Tremont Group Holdings (USD 3.3 billion losses). Renowned banks also incurred losses in the case of Madoff's operation. His company was the object of investments for, e.g., the Spanish Santander S.A., Austrian Medici A.G. and BNP Paribas[1].

In the published analyses of the 2008-2009 economic crisis, relatively little attention is paid to the role of financial information in the assessment of investment efficiency. However, the correctness of investment decisions depends chiefly on whether the investor has access to credible financial information. Only then it is possible to manage risks effectively.

2. Confidential financial information in investment decisions

If the prices of corporate assets in market transactions are based on information consciously manipulated in the name of particular interests, it will not serve the development of economy and only the interests of a small group of privileged people. J. Stiglitz refers to this group as stock adventurers. The situation is similar for confidential and corporate information. Using it in stock exchange transactions is described as insider trading or insider dealing. This corporate information may influence investment decisions but has not yet been announced publicly. It is not available to all market participants, only to a small group of people. These include persons holding executive posts in the company, financial analysts and external consultants such as, among others, lawyers, investment advisors and auditors.

Confidential information may include: planned mergers, planned defended takeover bids, forecasted correction of financial results, planned creation of provisions or obtaining a major commercial contract. The abovementioned persons belong to a privileged group, because they have the confidential information at their disposal. Information advantage of the insiders enables them to promote effectively financial instruments, increase revenues and achieve individual advantages. Securities and Exchange Commission includes in its definition of insiders those who have "temporary" or "constructive" access to the material information.

A case in point would be the so-called purchase options for the executive staff in some American corporations. They give their holders the chance to purchase stocks at preferential prices. The said information was not available on the market, because the American accounting standards do not impose the obligation to disclose it in financial reports. Executives holding the options exercised them during the bull market, knowing that the increase in the stock value had little to do with the results of their companies.

As noted by prestigious *Financial Times*, insider trading is not a new phenomenon. However, at present it has become more professional and institutionalized. Confidential and corporate information constitute the target for "large players" who anyway have a privileged position on the market. Many hedge funds are established which are interested in this course of action. There are also independent "expert networks" created which obtain such information for their purposes. A case in point here would be Primary Global Research[2].

In Poland, legal regulations in this respect are contained in the Act on trading in financial instruments (Journal of Laws Dz.U. No. 211/2010, item 1384). Pursuant to Article 156, anyone holding confidential information on account of position held within a company's governing bodies, profession or other legal relation may not: disclose confidential information, provide recommendations or encourage the purchase or sale of financial instruments to which the given information pertains. Violation of the regulations is punishable with a fine of up to PLN 5 million and imprisonment of up to 5 years. The basic argument in advantage of this kind of regulations is the fact that persons holding confidential information may use them not only to their own advantage, but also may influence other market participants through their investment decisions.

[1] Date of The Wall Street Journal, Polish Edition, 23.12.2008.

[2] Date of The Financial Times Limited, 2011, quotation from DGP-Gazeta Prawna, 11.03.2011.

Stock exchange listings show that stock prices grow not only in case of publishing good financial results. Stock price increase is observed also if the financial data published by the company is worse. Sometimes, stock prices go down despite the fact that a company has published relatively good financial results. Two types of information advantage may be distinguished in shaping stock prices:

1. Using confidential information (not published in financial reports).
2. Using knowledge as to the way of processing information (manipulating financial information which will be published in financial reports).

Above quoted G. Soros summed up this situation in a simple manner. During the period of boom, corporations are convinced that it is possible to increase earnings per share quickly through ostensible actions. Share value determines bonuses and additional benefits granted to corporate executives (Soros, 2010, p. 99). Ostensible actions consist in processing financial information in such a way so as to encourage external investors to buy shares. Higher share demand increases their market price.

3. Systemic and particular conditions for financial information

The need for accounting standards was very accurately put by S. Tanaka. In his opinion, it is a creation of a map of economic events in a strictly determined structure and with the use of unified concepts. Thus something along the lines of "business language" is created (Tanaka, 1982, p. 4). This language serves the purpose of describing corporate resources, the sources of their financing, revenues, costs and cash flow. The purpose of accounting standards is for the financial report to reflect a credible picture of the company's financial standing. It should also be synthetic, clear and comparable to the reports of other companies. It is the necessary condition for effective capital allocation. Globalization, the growing number of international corporations and the development of modern information technologies results in the need for an "international business language". It is a condition precedent for good investment decisions, both for individual and institutional investors.

Accounting standards require certain rule-making, such as legal provisions, guidelines, procedures and recommendations. These rules take into consideration the specificity of the accounting system in a given country and pertain to three issues:

- description of an economic event;
- measurement of the economic event (valuation);
- form of presenting financial information.

An interesting analysis of accounting systems was presented in early 1980s by C.W. Nobes. Above all, he distinguished the countries in which the accounting system is corporate-oriented (microeconomic approach) or economy-oriented (macroeconomic approach). The first group of countries included, among others, Australia, the USA, Great Britain and the Netherlands, while the other Germany, Japan, France, Belgium, Italy and Spain. The basis for this distinction was the analysis of the following factors (Nobes, 1984):

- legal systems;
- stock exchanges as the source of obtaining capital;
- tax systems;
- significance of the environment of auditors and accountants.

It is easy to note that these factors depend on cultural values, political system and even the history of respective countries. They constitute the premises for an accounting system characteristic of the given country. In consequence, accounting systems differ from one another and do not ensure full comparability of financial information. Furthermore, within the national accounting systems companies have the possibility to choose the method of asset valuation and of presenting the measurement of economic events. The most important among them include:

1. Asset valuation: at historical cost, at current cost or at settlement value.
2. Stocks valuation: according to FIFO (*first in first out*), LIFO (*last in first out*) or average consumption cost methods.
3. Estimation of provisions and conditional liabilities.
4. Settlement of research and development costs and depreciation of fixed assets.

The possibility of selecting specific detailed solutions arises from the accounting principles binding in the given country. They are established statutorily or through recommendations, in conformity with the binding accounting system. The condition of comparability of financial information is therefore the international standardization of financial information. It should be aimed at limiting the possibility of choosing the standard and at adopting uniform accounting principles.

Differences between respective accounting systems are so significant that they may lead to erroneous investment decisions. An example for the above statement may be the differences in the value of the balance sheet profit, calculated on the basis of various accounting systems (Table 1).

Table 1. Balance sheet profit according to various accounting standards

Company / country	National accounting standards*	International accounting standards	Generally accepted accounting principles
Hoechst Germany 1993		USD 1212 million	USD 625 million
Daimler Benz Germany 1993	DM 615 million		(-) DM 1839 million
Euro Disney France 1996	FF 202 million		(-) FF 1021 million
Deutsche Telekom Germany 2005		EUR 5584 million	EUR 5325 million
GlaxoSmithKline Great Britain 2005		GBP 4816 million	GBP 3336 million

Note: * in accordance with: Deutsche Rechnungslegungs Standards Committee (DRSC), Conseil National de la Comptabilitè (CNC), Accounting Standard Board (ASB).
Source: IASC INSIGHT, quotation from Międzynarodowe regulacje rachunkowości, edited by A.A. Jaruga, C.H. Beck, Warszawa 2002 and the typescript by R. Cieślik, Warsaw University, Faculty of Management, Warszawa 2009.

It turns out that the balance sheet profit looks more favourable if it is calculated according to national standards (Germany, France) or the international accounting standards (Germany, Great Britain). Profits calculated according to the American GAAP system are decidedly lower and in the case of Daimler Benz and Euro Disney they even constitute balance sheet losses.

Apart from the lack of comparability of financial information, an important factor in investment decisions is the scope of information presented in reports. Non-provision of sensitive information falls within the corporate information policy. Management boards are not always interested in providing access to information which could influence the assessment of their work or could be used against the interests of the corporate management board. Publishing such information may result in a situation when stockholders would question the justifiability of management board decisions, creditors would limit their financing and the competition would become familiar with the company's weak spots. Therefore financial information should be processed according to specific standards so that the contents and form of a financial statement meet the requirements of external users and not those who deliver the said information. It pertains in particular to financial reporting presented in aggregated form. Consolidated reports of capital groups are meant here. An investor has at his disposal the final results of a capital group, but he is unable to assess the underlying profit-generating factors. These are, however, the necessary information for estimating risk and making an investment decision.

Summing up, I would like to stress once again that the possession of financial information constitutes an advantage for one of the parties to market transactions. The diverse nature of accounting systems and relative freedom in the choice of accounting methods makes it possible to create a more advantageous corporate image. The above phenomenon is called creative accounting. It is understood as falsely optimistic form of accounting, which, however, is not prohibited formally. It may be used because not all transactions are subject to regulations and in some cases regulations are not explicit[1]. An extreme sign of manipulating financial information is accounting fraud. According to international accounting standards, conscious and false presentation or omission of significant information in financial statements, on the basis of which the information user makes the decision, is called a fraud[2]. That correspond not with the facts. As written by J. Sachs: "Hardly a day passes without a new story of malfeasance. Every Wall Street firm has paid significant fines during the past decade for phony accounting, insider trading, securities fraud or outright embezzlement by CEOs… When companies are fined for malfeasance, their shareholders, not their CEOs and managers, pay the price. The fines are always a tiny fraction of the ill-gotten gains, implying to Wall Street that corrupt practices have a solid rate of return" (Sachs, 2011).

In view of the lack of credible and uniform financial information, those in charge of managing the capitals in a corporation are better informed of its financial standing than capital managers who base their knowledge solely on financial statements.

4. Information quality according to IAS and US GAAP

From the point of view of the external user of financial information, the financial statement is of key importance. It was reflected both in the American GAAP accounting system and in the International Accounting Standards.

Pursuant to the American assumptions (General Purpose External Financial Reporting) the objec-

[1] Dictionary of Finance and Banking, Oxford University Press, 2005, Polish Edition by PWN SA, Warszawa 2008.
[2] On the basis of the Accounting Standards as of June 1, 2000, John Wiley & Sons, Inc. NY 2000.

tives of financial reporting pertain above all to the information requirements of external users who are not able to impose the contents of financial information, the provision of which they would expect from a given enterprise, and hence must use the information presented by its management. According to SFAC No. 1, the goal of financial reporting is to provide useful financial information for current and potential investors, creditors and other users who make their economic decisions on its basis. In particular, this pertains to assessing the value, time-limit and risk related to cash flow on account of dividends, interest, sale of securities or repayment of loans (Accounting Standards, p. 16, 18).

The goal of financial statement is put slightly differently in the International Accounting Standards. According to IAS No. 1, its goal is to present information on the financial standing, operating results and changes in the financial situation of an enterprise which would be useful for a wide group of users upon making economic decisions[1]. In other words, the purpose is to present a true and fair financial view of the enterprise.

External users of financial statements include:

- investors; entities investing their capital are interested in the risk and expected rate of return on their investments. The said information is required for the purpose of making a decision on acquisition, holding or sale (of stock, shares and other financial instruments);
- lenders and creditors; capital providers expect information which would enable them to asses whether the credits and loans granted together with the interest due on them would be paid on time;
- suppliers and recipients; trade partners are interested in information on the solvency of the given enterprise and any potential risks to going concern. It is important from the point of view of stable commercial cooperation, in particular if the business partners are economically dependent on the given entity;
- government and public administration institutions; these bodies are interested in the information on operating results and enterprise development directions. It is necessary for shaping the economic policy on the national and regional level as well as for statistical purposes.

As noted by A. Jaruga, financial statements are directed chiefly at investors supplying the capital. They are meant to secure their interests, i.e., enable risk assessment and estimation of rate of return. On the other hand, information needs of other users are satisfied "unintentionally", so to say. It is possible because of the specific quality features of financial information. It does not mean, however, that financial information can satisfy all the expectations of its potential users (Jaruga, p. 84).

The condition necessary for a financial statement to be an effective risk assessment tool is the quality of the financial information contained in the report. In other words, financial information should be useful for the persons making a decision on its basis. The quality features of financial information (*Qualitative Characteristics of Accounting Information*) are specified both in IASB and SFAC No. 2 (Gabrusewicz, 2011, p. 36-27):

1. The information should be understandable to its users; financial information should be prepared in such a way so as to enable its users to read its contents correctly and analyze the figures contained therein. Unclear information is useless.
2. The information should be significant; this is the feature of information which pertains to issues significant for making the decision. Information is significant if its omission or distortion could influence the decisions made by the users (investors).
3. The information should be credible; this is the feature of information which reflects in a true and objective way economic events and the company's image. Information is not reliable if it is the result of accounting manipulations aimed at making the investors take specific decisions.
4. The information should be comparable; this is the feature of information which is of prognostic value. This feature renders it possible to compare the reporting information with information from previous periods and information presented by other entities from the given industry. It enables the investors to assess and compare rates of return.

Conclusion

Summing up, I would like to stress that financial statements do not contain all the information necessary for making correct investment decisions. Their scope is specified by the accounting system binding in the given country. Should there be no relevant regulations, corporations may limit the amount of information disclosed on account of their information policy or for purely commercial reasons. Managing accounting books and processing information according to specified standards constitute a cost. Therefore, the standardization of financial information and the mode of its presentation constitute the basic condition necessary for decreasing information advantage and ensuring the transparency of market transactions. It is important that information standardization take place globally, and not only within specific countries or regions.

[1] On the basis of the International Accounting Standards Board, Stowarzyszenie Księgowych w Polsce, Warszawa 2007.

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