Financial reporting: from shadows to limelight

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This evening, I would like to share with you some reflections on financial reporting. At first sight, the choice of topic may appear somewhat surprising. Accounting is not a matter that, until recently, generated much excitement. In a sense, accountants were regarded as the scorekeepers of the economic game: necessary, certainly, but inherently less interesting than the real players.

Well, now we know differently. Scorekeepers may or may not have a material influence on the outcome of sporting events. But financial reporting can certainly have a major effect on the way the economic game is played. In the light of recent events, it is hard to dispute that high quality financial reporting is essential for the efficiency and stability of the financial systems. It is the cornerstone on which market discipline - a key theme of this conference - rests. But it is a subject that has regrettably not commanded the attention it deserves among researchers on financial stability.

In my remarks today, I will first make the case that financial reporting has become increasingly important and intellectually challenging. I will then highlight some issues that merit particular attention. Lastly, I will draw some conclusions on the way forward for policymakers and academic research.

I. Why should we (increasingly) care?

Broadly defined, financial reporting covers the mechanisms for providing information about the financial condition, performance and, importantly, risk

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profile of firms to all potential users. It is, therefore, one of the most basic elements of the financial infrastructure.

The information supplied serves a dual purpose. First, it has a *signalling* function. It facilitates the identification of the most productive uses of economic resources. As such, it forms the basis for assessments of prospective returns and risks. Second, it has a *control* function. It facilitates control over the effective utilisation of those resources. As such, it forms the basis for the allocation of income among the various claimants on the firm and the exercise of financial discipline.

When put in these terms, the critical role of financial reporting is obvious. It is hard to imagine how an efficient and sound financial system could operate without meaningful and reliable financial reporting.

And yet, perhaps precisely because its role is so obvious, financial reporting is easily taken for granted. Indeed, there is a rather common strand of thought in finance that would contend that market processes generate the necessary information spontaneously, regardless of what the financial reporting standards might be. Markets are an all-seeing eye guiding an invisible hand.

This is not a view I can agree with. *Conceptually*, it fails to recognise that information is both costly to produce and to interpret. Since, by definition, the costs of producing public information are private but the benefits accrue to all potential users, there is a bias to under-supply. And conflicts of interest abound. Those seeking external funding would naturally like to paint a rosy picture of prospects. And given the difficulties in charging potential users, it is generally firms themselves that pay those that produce or certify the quality of the information, such as accountants, auditors, rating agencies or, in some cases and indirectly, stock analysts. Reputation need not be a sufficiently restraining force to ensure quality.

*Empirically*, the presumed omniscience of markets sits uncomfortably alongside the attention that management and investors pay to the bottom-line accounting numbers. Or with management’s resistance to proposed changes in standards that would make the numbers look less attractive, such as the expensing of options or tighter consolidation rules. The following extract from the risk management manual of a once dominant firm is instructive:

> “Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with underlying economics. However, corporate management’s performance is generally measured by accounting income, not underlying economics. Risk management strategies are therefore directed at accounting rather than economic performance”.

Recent experience has hammered this message home with a vengeance. The demise of Enron, the firm from whose risk management manual this quote was
taken, has revealed that even the most advanced financial systems are not immune from deficiencies in financial reporting. The more generalised market reaction suggests that, if Enron is an extreme case, it is seen as symptomatic of deficiencies elsewhere. Indeed, in the aftermath of the high-tech equity bubble, an increasing number of distortions in the provision of information have come to light, badly affecting confidence in the integrity of market information. Another, somewhat different, instance was LTCM, which was able to operate while supplying only minimal information to counterparties and markets about its risk profile. And, more generally, the harmful effects of shortcomings in financial reporting have been highlighted by financial crises in emerging and industrial countries alike. The lack of transparent and reliable accounts, for instance, contributed to the build-up of financial imbalances and to the virulence of the Asian crisis.

The bottom line is simple. Misplaced trust in the quality of the information supplied or in the ability of the market to overcome its limitations can severely impair the functioning of the financial system. It can do so by allowing the misuse of economic resources and by undermining confidence in the very fabric of the system once those limitations are exposed.

Important as financial reporting has always been, recent structural developments in the financial system have raised its significance even further. First, the shift from relationship banking to transaction finance has naturally put a premium on the disclosure of public information. Second, the globalisation of markets has increased the need for comparability of information. Third, a myriad of financial innovations and new financial structures has made balance sheets harder to read. Finally, and more subtly, financial liberalisation has allowed perceptions of value and risks to become more important drivers of economic activity and business fluctuations. These perceptions are vulnerable to abrupt reassessment in the light of new information. Disruptive financial booms and busts can find more fertile ground where the raw information is distorted or simply unavailable.

Not only has financial reporting become more important, it has also become more intellectually challenging. The complexity of new instruments for risk transfer and of corporate structures has tested the limits of existing measurement techniques. And the same is true of the growing importance of intangibles, such as intellectual properties and branding, in the value attached to economic activity.

II – Selected issues

Against this background, let me next highlight a number of issues that, to my mind, merit particular attention. While by no means exhaustive, the list is
sufficient to illustrate the stakes involved and the complexity of the subject. The issues relate, respectively, to the scope, content and reliability of information.

As regards scope, the information should cover measures of value, cash flow and income, on the one hand, and of the variability or uncertainty associated with them, on the other. For now, think of these two types of information as referring, respectively, to the first and higher moments of the corresponding probability distributions. Information conveyed by the balance sheet, income and cash flow statements is of the first type; risk information is of the second. The former is the bread and butter of traditional accounting; the latter is primarily supplied through supplementary risk disclosures.

Both are important for an efficient allocation of resources and financial discipline. Arguably, for instance, many of the distortions in the functioning of the financial system arise because too much attention is paid to profits and rates of return and too little to the concomitant risks. By comparison with the development of mainstream accounting information, that of risk information is of more recent vintage. It has been spurred by the emergence of a more volatile financial environment but hindered by the initial rudimentary state of risk measurement, inhibited by a prolonged period of financial repression in the post-war era. Prudential authorities have played an important role in making progress, particularly by encouraging risk disclosures as a means of enhancing market discipline. Pillar III in the revised Basel Capital Accord is just the most recent example of this trend. This task should be vigorously pursued, and ideally extended to encompass action by accounting authorities too. I will return to this in a moment.

As regards content, arguably one of the hardest nuts to crack is the treatment of non-traded assets. The key challenge is to close the gap between economic and accounting valuations. It has been recognised for some time that the prevailing mixture of historical cost and mark-to-market accounting is unsatisfactory. But how best to modify it has been a major bone of contention. If all assets and liabilities were traded in efficient markets, marking to market would be less controversial. But for non-traded instruments, valuations must be imputed, and there is no agreement on how best to do this. Not least, verifiability becomes a key concern.

A broad array of specific issues fall under this general rubric, from the valuation of intangibles, to hedge accounting, to how to account for contracts involving very long-term streams of payments and receipts. These issues apply both to financial and non-financial firms. The key questions, however, can be illustrated with reference to the current debate on how to value loans, and hence how to provision for credit losses.

There is general agreement that, if properly designed, more forward-looking provisioning would bring accounting valuations closer to underlying economic
valuations. In particular, waiting for default to be highly probable before a provision can be made fails to recognize deteriorations in credit quality short of probable default. Accordingly, it also tends to introduce artificial cyclicality in bank profits.

At the same time, there is no agreement on how best to impute valuations. Fair value proposals would discount expected cash flows at a rate drawn from “similar” instruments traded in the market. Certain dynamic provisioning variants, such as the statistical provisions introduced by the Bank of Spain, would tend to average provisioning expenses over the business cycle based on long-run loss experience. And the current IASB proposal, broadly speaking, calls for discounting expected cash flows at the (fixed) internal rate of return on the loan at origination. This approach has the merit of having loan values reflect deteriorations in credit quality while at the same time avoiding the volatility arising from movements in market liquidity and risk premia. Many believe, however, that it does so at the cost of putting a somewhat larger burden on verifiability than is the case under current practices for specific provisions.

Different approaches can have first order effects on measures of net worth and income. Clearly, appropriate loan valuation is as important as the specification of the capital standards that should apply to them. For a number of understandable reasons, however, we have not until recently given this matter the attention it deserves.

The previous illustration also indicates that deciding on the “right” measures of value may require balancing various considerations. Doing so can give rise to differences of opinion that may in part reflect differences in perspectives. A case in point is the distinction between “true and fair” valuations, on the one hand, and “conservative” valuations, on the other. Other things equal, accountants tend to stress the former, while prudential authorities are instinctively somewhat more receptive to the latter, given their focus on downside risks. In fact, one concern sometimes raised with regard to fair value accounting is that greater reliance on market values would not strengthen prudential safeguards whenever asset price misalignments are at the origin of financial instability - a not uncommon occurrence.

As the dialogue about appropriate measurement proceeds, such differences in perspective are likely to continue to narrow. Differences partly reflect the fact that a common conceptual framework and even a common language have not yet fully emerged. Still, the process of developing standards has been extremely helpful in encouraging the development of a common approach. For instance, work on the new Capital Accord has been contributing to a better understanding of the relationship between expected losses, unexpected losses, pricing and provisioning. By the same token, it has been paving the way towards a sharper recognition of the distinction between measures of valuation, on the one hand, and of their uncertainty or risk, on the other.
To be more precise, let me venture here a tripartite distinction of the information required, depending on the type of measure of risk and uncertainty involved. First, there are point estimates of current value and income. Second, there is risk associated with the statistical dispersion of future outcomes for value and income. This is what is often captured through the probability distributions that underlie risk calculations. Thirdly, there is uncertainty associated with the imperfect modelling of both joint estimates and measures of statistical dispersion. Such uncertainty applies with particular force to non-traded instruments.

A simple example can illustrate this classification. A portfolio of loans has an estimated value at a point in time. We can in addition construct a full probability distribution for the dispersion of possible future outcomes, e.g. to derive a credit value-at-risk measure. Finally, depending on the robustness and verifiability of the assumptions made, there is a margin of error attached to those two types of estimate themselves. For example, for a fair value estimate of the current value of a loan, the margin of error increases as the correspondence with available traded instruments becomes more tenuous.

In my view, we have been devoting great attention to developing point estimates of current values and of their future dispersion, but not enough, if any, to estimates, however rough, of the uncertainty attaching to them. And yet, all of them are important. Analytic research is badly needed here.

One can ultimately imagine a situation in which financial statements would include estimates of these various types of information, while prudential controls would be set to create the desired cushions and other safeguards against the corresponding risks and uncertainties. The alternative of setting such cushions through conservative valuations can hinder transparency.

The issue of the appropriate valuation of bank loans has hardly made headlines. It is the controversy over the treatment of equity-based remuneration, in particular options, that has stolen the scene. Here, too, depending on the features of the instruments, some of the questions relevant for non-traded assets can apply, including the difficulties in modelling the price and the verifiability of the corresponding estimates. But the more fundamental issue is whether such options should be treated as a cost at all. At present, they typically are not.

Personally, I find this treatment hard to justify. Simply put, no one provides a service for free, at least intentionally. The cost of that service must be recognised in the accounts. It dilutes the income of existing shareholders. By recognising it, a better indication is conveyed of the running costs of a business, one not distorted by expectations of price appreciation in the means of payment.

As regards the reliability of the information supplied through financial reporting, I would simply like to draw your attention to two issues. The first is
the choice between rule-based and principles-based standards. The second is the issue of incentives generally, and conflicts of interest in particular.

Within the accounting and auditing profession there has been a long-standing debate over the relative merits of principles and detailed rules in the articulation of accounting standards. True, the difference between the two approaches can be easily overemphasised: principles need to be given added content before they can be effectively applied and enforced. Even so, important differences remain. While the debate may appear arcane to the non-initiated, it is of significant practical relevance.

In my opinion, the growing capacity for financial engineering and innovation in today’s financial system tips the balance decisively in favour of principles-based standards. Detailed rules have become simply too easy to circumvent through what has euphemistically been called “aggressive accounting”. Indeed, for much the same reason prudential authorities have been shifting the emphasis away from quantitative rules towards qualitative supervisory oversight in recent years. While more onerous on supervisors, such a shift is more consistent with the much enhanced ability of markets to arbitrage restrictions away.

It is easy to think of illustrations of this point. One example is the treatment of leases. It is puzzling, to say the least, that airlines can routinely operate without showing any planes on their balance sheet. Consolidation standards are another. A mild proposed tightening of the detailed quantitative standards for consolidation of special purpose entities in the United States is estimated to bring back onto balance sheets large amounts of corporate debt. The change has met with stiff opposition. The bottom line is simple. By operating as close to the wind as possible companies can adhere to the letter of the rule while violating its spirit. In the process, valuable resources are wasted and information is distorted.

But the reliability of information is not just a function of how the standards are articulated. More fundamentally, it depends on the incentives for producing, certifying and interpreting it. After all, the Enron case shows that, while the complexity of the rule book may facilitate questionable accounting practices, incentives can play a key role, as indicated by the charges of fraud and the criminal investigation of the auditing firm involved.

Inevitably, as heady a bull market as the recent one distorts incentives. Greed takes over from fear. The imperative to succeed in the short run gains force. The ante is progressively raised as the market soars. It is simply not in human nature to ask tough questions when the going is good. And the tendency to remunerate through equity, instead of aligning incentives between managers and shareholders may, if taken too far, actually distort them. Managers have a greater incentive to inflate the value of the means of payment, i.e. the shares, by massaging the pieces of information that are closely watched by outsiders.
But, as is well-known, structural conflicts of interest can add fuel to the fire. Questions should be and are being asked about the fact that the remuneration of those that produce or certify the information has been increasingly tied to services that can undermine the required independence and objectivity of judgement. For instance, equity analysts’ pay has been partly tied to investment banking mandates. And a growing proportion of auditing firms’ income has come from consulting services. Even rating agencies have been moving in the same direction.

These issues will need to be addressed. Finding the appropriate answers requires careful thought. As suggested above, the issue of what arrangements are most suitable to ensure reliable information, and particularly how the information should be paid for, are especially difficult, given the public good properties of the service. Hasty solutions should be avoided. In fact, the task is a broad one indeed. A solution ultimately hinges on ensuring a mutually supportive role of internal and external governance mechanisms, including that of official bodies with enforcement powers.

Let me conclude. As my remarks have made clear, the challenges involved in strengthening financial reporting should not be underestimated. They range from tough conceptual questions to inevitable political economy obstacles to change. The stakes are high. Ultimately, better financial reporting holds the promise of a more efficient allocation of financial capital in our global economy and a sounder and more stable financial system. By the same token, it can bring within reach a better balance between market and official discipline. Recent developments provide an invaluable opportunity for further progress. The growing dialogue between accounting and prudential authorities is bringing closer together two essential elements of financial reporting. Moreover, the markets’ strong reaction to the revelations of information deficiencies should give impetus to considered action.

I hope I have also convinced you that there is no dearth of intellectually alluring challenges in this field. We need more and better analytical and empirical work. What is the best way to define and articulate the information needed for markets to function effectively? What mechanisms can best ensure that that information is indeed supplied? Answers to these questions are critical for better policy. We, as policy makers, will be eagerly awaiting them.
Limelight Networks, Inc. (Nasdaq: LLNW) (Limelight), a leading provider of video delivery and edge cloud services, today reported record revenue of $59.2 million for the third quarter of 2020, up 15 percent, compared to $51.3 million in the third quarter of 2019. Issued $125.0 million senior convertible notes due 2025. Limelight reported a GAAP net loss of $4.0 million, or $(0.03) per basic share for the third quarter of 2020, compared to a net loss of $2.8 million, or $(0.02) per basic share in the third quarter of 2019. Limelight Control provides unified reporting and management and lets you analyze your data using visualizations that deliver immediate insights. Click here to learn more about how our management works. Integrated Configuration and Management Portal. Limelight Control is a secure self-service portal that makes it easy to configure, manage and monitor the Limelight platform. You can purge erroneous or outdated assets, create and manage a range of delivery configurations, track performance, and troubleshoot issues. The Limelight Control self-service UI and APIs are fully compatible, supporting DevOps environments and ensuring compatibility regardless of your workflow. Unified Reporting. Limelight is the next-generation of Excel offering data integration, collaboration and control. We go live at 2 PM tomorrow with our How To Plan Better and Report Faster Out of Sage Intacct webinar. A survey of CFOs found that digital financial transformation leads to better decision-making. Read more from @CFODive here: https://hubs.ly/H0zlSpt0 #Limelight #finance #cfo. Almost a third of CFOs said several financial digital transformation initiatives have stalled or stagnated amid the pandemic, at great cost to their organizations, a Workday survey found. cfdive.com. Survey: Digital transformation in finance a key agility indicator. Limelight reported a GAAP net loss of $4.0 million, or $(0.03) per basic share for the third quarter of 2020, compared to a net loss of $2.8 million, or $(0.02) per basic share in the third quarter of 2019. GAAP net loss included $1.7 million of interest expense related to our convertible notes issued during the third quarter of 2020. Limelight ended the third quarter with 620 employees and employee equivalents, down from 627 at the end of the second quarter of 2020, and up from 609 at the end of the third quarter of 2019. Q3 was a very strong quarter for us on a number of fronts as we experienced our second highest quarter of revenue ever and made material progress across our strategic imperatives. Limelight posted unexpectedly weak results in the quarter. Competition heating up. Bullish sentiment for Limelight Networks (LLNW) collapsed after the company posted weak quarterly earnings. Instead of beating expectations like it did last quarter, Limelight’s CEO alerted analysts to severely disruptive headwinds ahead. It cited everything from Covid-19 risks to large customer order slowdowns. Limelight lost one-third of its value last week. The pre-earnings buy may have earned over 10% in gains but the investor lost the war as a buyer. Below, LLNW stock cratered after the quarterly report: Limelight won several edge deals and continued to progress its strategic plan. For example, it expanded its developer community. This will improve customer uptake over the next few quarters.