Notes

1 G. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* (August 1970): 488–500. Akerlof recognized that the seller of a used car knew more about the car's value than the buyer. This meant that the buyer was likely to end up overpaying, since the seller would accept any offer that exceeded the car's true value and reject any lower offer. Car buyers recognized this problem and would respond by making only average-quality offers for used cars, leading sellers with high quality cars to exit the market. As a result, only the lowest quality cars (the "lemons") would remain in the market. Akerlof pointed out that qualified independent mechanics could correct this market breakdown by providing buyers with reliable information on a used car's true value.

2 The IFRS Standards refer to the balance sheet as a "statement of financial position." However, firms are free to choose other titles. Throughout this book, we will refer to the five statements as the income statement, the balance sheet, the cash flow statement, the statement of other comprehensive income, and the statement of changes in equity, which is how they traditionally have been – and still are – called by users of financial statements.

3 Firms are allowed to combine the income statement, which describes the composition of profit or loss, and the statement of other comprehensive income, which describes all other non-owner changes in equity, into one statement.

4 There is no globally accepted name for management's narrative discussion of the firm's performance. In 2010 the IASB issued a (non-binding) Practice Statement Management Commentary, advising on what firms should report in this section. Throughout this book, we will refer to this section as the Management Commentary section, consistent with the IASB's labelling, and assume that it typically contains at least a Letter to the Shareholders and a review of the firm's financial performance during the fiscal year and its financial position at the end of the year.

5 These definitions paraphrase those of the IASB, "The Conceptual Framework for Financial Reporting" (also referred to as the "Conceptual Framework"). Our intent

is to present the definitions at a conceptual, not technical, level. For more complete discussion of these and related concepts, see the IASB's Conceptual Framework.

6 The EU has given its individual member states the option to permit or require private companies to use IFRS Standards for the preparation of their single entity and/or consolidated financial statements. Similarly, member states may permit or require public companies to prepare their single entity financial statements in accordance with IFRS Standards.

7 For a comprehensive overview of European legal liability regimes, see C. Gerner-Beuerle, P. Paech, and E.P. Schuster, "Study on Directors' Duties and Liability" (April 2013) or the European Securities and Markets Authority's "Comparison of Liability Regimes in Member States in Relation to the Prospectus Directive" (May 2013). For a description of international differences in managers' legal liability for the information that they provide in prospectuses, see R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, "What Works in Securities Laws?" *The Journal of Finance* 61 (2006): 1–32.

8 See, for example, the UK HM Treasury's report (July 2008) on the "Extension of the Statutory Regime for Issuer Liability," describing motivations for making managers subject to civil liability for fraudulent misstatements only.

9 The ESMA has issued guidelines on how enforcers should select the companies they review, advocating a combination of risk-based selection with random sampling or rotation. See "ESMA Guidelines on Enforcement of Financial Information" (July 2014).

10 See H.E. Jackson and M.J. Roe, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence," *Journal of Financial Economics* 93(2) (2009): 207–238.

11 See Sarah Tasker, "Bridging the Information Gap: Quarterly Conference Calls as a Medium for Voluntary Disclosure," *Review of Accounting Studies* 3(1–2) (1998): 137–167.

12 See Richard Frankel, Marilyn Johnson, and Douglas Skinner, "An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium," *Journal of Accounting Research* 37(1) (Spring 1999): 133–150.

13 See M. Kimbrough, "The Effect of Conference Calls on Analyst and Market Underreaction to Earnings Announcements," *The Accounting Review* 80(1) (January 2005): 189–219.

14 Research on voluntary disclosure includes Mark Lang and Russell Lundholm, "Cross-Sectional Determinants of Analysts' Ratings of Corporate Disclosures," *Journal of Accounting Research* 31 (Autumn 1993): 246–271; Lang and Lundholm, "Corporate Disclosure Policy and Analysts," *The Accounting Review* 71 (October 1996): 467–492; M. Welker, "Disclosure Policy, Information Asymmetry and Liquidity in Equity Markets," *Contemporary Accounting Research* (Spring 1995): 801–827; Christine Botosan, "The Impact of Annual Report Disclosure Level on Investor Base and the Cost of Capital," *The Accounting Review* (July 1997): 323–350; and Paul Healy, Amy Hutton, and Krishna Palepu, "Stock Performance and Intermediation Changes Surrounding Sustained Increases in Disclosure," *Contemporary Accounting Research* 16(3) (Fall 1999): 485–521. This research finds that firms are more likely to provide high levels of disclosure if they have strong earnings performance, issue securities, have more analyst following, and have less dispersion in analyst forecasts. In addition, firms with high levels of disclosure policies tend to have a lower cost of capital and bid-ask spread. Finally, firms that increase disclosure have accompanying increases in stock returns, institutional ownership, analyst following, and share liquidity. In "The Role of Supplementary Statements with Management Earnings Forecasts," *Journal of Accounting Research* 41 (2003): 867–890, A. Hutton, G. Miller, and D. Skinner examine the market response to management earnings forecasts and find that bad news forecasts are always informative but that good news forecasts are informative only when they are supported by verifiable forward-looking statements.

15 See J. Cotter, I. Tuna, and P. Wysocki, "Expectations Management and Beatable Targets: How Do Analysts React to Explicit Earnings Guidance," *Contemporary Accounting Research* 23(3) (Autumn 2006): 593–628.

16 The EU Accounting Directive (Directive 2013/34/EU), which governs the preparation of single and consolidated financial statements in the EU, defines large groups as those meeting at least two of the following three criteria in two consecutive years:
   1 Total assets above €20.0 million.
   2 Annual turnover above €40.0 million.
   3 More than 250 employees.

17 The EU Accounting Directive (Directive 2013/34/EU) defines small corporations as those failing to meet two of the following three criteria in two consecutive years:
   1 Total assets above €6.0 million.
   2 Annual turnover above €12.0 million.
   3 More than 50 employees.

18 It should be noted that although the EU regulations have partly harmonized private corporations' accounting, the accessibility of public registers varies greatly and private corporations' financial statements are therefore in practice not equally available across the EU.

19 See R. Ball and L. Shivakumar, "Earnings Quality in UK Private Firms: Comparative Loss Recognition Timeliness," *Journal of Accounting and Economics* 39 (2005): 83–128; D. Burgstahler, L. Hail, and C. Leuz, "The Importance of Reporting Incentives: Earnings Management in European Private and Public Firms," *The Accounting Review* 81 (2006): 983–1016; E. Peek, R. Cuijpers, and W. Buijink, "Creditors' and Shareholders' Reporting Demands in Public versus Private Firms: Evidence from Europe," *Contemporary Accounting Research*

27 (2010): 49–91; and M. Clatworthy and M. Peel, "The Impact of Voluntary Audit and Governance Characteristics on Accounting Errors in Private Companies," *Journal of Accounting and Public Policy* 32 (2013): 1–25.

20 The influence of tax rules is particularly strong on single company financial statements, which in many countries are the basis for tax computations. Although the influence of tax rules on consolidated financial statements is less direct, tax considerations may still affect the preparation of these statements. For example, companies may support their aggressive tax choices by having the consolidated statements conform to the single company statements.

21 See L. Bottazzi and M. Da Rin, "Venture Capital in Europe and the Financing of Innovative Companies," *Economic Policy*, April (2002): 231–269.

22 See L. Bottazzi and M. Da Rin, "Europe's 'New' Stock Markets," Working Paper, July 2002; and M. Goergen, A. Khurshed, J.A. McCahery, and L. Renneboog, "The Rise and Fall of European New Markets: On the Short and Long-run Performance of High-tech Initial Public Offerings," Working Paper, European Corporate Governance Institute, September 2003. To be eligible for a listing on one of the two largest new markets, the Nouveau Marché and the Neuer Markt, companies had to meet all of the following admission requirements. First, companies' equity prior to the initial public offering (IPO) had to exceed €1.5 million. Second, companies had to issue more than 100,000 shares, which had to represent more than 20 percent of the companies' nominal capital, at an amount exceeding €5 million. Third, not more than 50 percent of the shares issued were allowed to come from existing shareholders; more than 50 percent of the issued shares had to come from a capital increase. Fourth, managers were not allowed to trade their shares during a six-month period following the IPO on the Neuer Markt. Managers of companies listed on the Nouveau Marché could not trade 80 percent of their shares for a period of 12 months. The other new markets had very similar admission requirements.

23 For an illustration of the circumstances surrounding the IASB's decision to amend the reclassification rules, see P. André, A. Cazavan-Jeny, W. Dick, C. Richard, and P. Walton, "Fair Value Accounting and the Banking Crisis in 2008: Shooting the Messenger," *Accounting in Europe,* 6 (2009): 3–24.