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DISCUSSION

STANLEY BAIMAN*: This paper raises some subtle issues which may have important implications for the interpretation of some results from the empirical research in financial accounting. In particular, the author's early discussion implies that the information content studies in financial accounting should be more carefully structured so as to isolate the information content of messages not on average but relative to the specific data base existing at the time of the announcement. In general, however, the paper discusses some possible causes of externalities arising from decentralized corporate financial reporting and methods for controlling these externalities.

In order to comment on this paper, I must first distinguish between two concepts: interdependence and externality. An interdependence between two firms exists when the action taken by one firm affects the other. This may occur because the cost or benefit to the second firm from any element in its set of action choices is affected by the action taken by the first firm. An externality arises when this interdependence gives rise to a misallocation of resources. In particular the interdependence between the two firms is such that the results of decentralized decision-making by each firm is Pareto-inferior to a centralized solution. Thus the existence of interdependencies is a necessary but not a sufficient condition for the existence of externalities and the Pareto-inferiority of decentralized decision-making.

The definition of externality offered by the author is equivalent to my definition of interdependence. It does not assume a misallocation of resources as a result of decentralized decision-making. This non-traditional definition of externality makes the purpose of the paper unclear.

To begin with, at equilibrium every commodity in the economy is interrelated with every other commodity. Thus, the price of shoes is related to the number of diesel engines produced. Therefore saying that corporate financial reporting produces interdependencies (or externalities as defined by the author) within the economy says very little.

Further, the author states as his purpose "... to guide future empirical research on the significance of and problems in "controlling" externalities in financial reporting". But what is there to control if there is no misallocation of resources as a result of decentralized corporate financial reporting? That is, while the author does not define an externality to include the misallocation of resources, the second part of the paper in which he discusses traditional methods of controlling externalities makes no sense unless he does. Further, the second part of the paper is premature unless and until the author demonstrates that the implicitly assumed misallocation of resources does result from decentralized corporate financial reporting. But no where in the paper is this demonstrated.

I emphasize that given the author's aim of providing an analyses "... to guide future empirical research on the significance of and problems in "controlling" externalities in financial reporting" it is not enough to implicitly assume that

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decentralized corporate financial reporting gives rise to the misallocation of resources. For the paper to achieve its stated aim it should first analyze how corporate financial reporting affects the allocation of resources in the economy. It should analyze conditions under which decentralized corporate financial reporting gives rise to externalities (as I have defined them). And most important for guiding empirical research, such a paper should analyze how and where these externalities, if they do exist, would be manifested. For without knowing where to look for the effects of externalities one cannot measure their effect in order to determine if they are worth controlling. Unfortunately the present paper does not provide this kind of potentially useful analysis.

While the author ends with a call for more empirical research in this area my call is for analytical research of the type I have suggested. The reason for the dearth of empirical research in this area is that we do not as yet know where to even look for evidence of the effect of externalities in corporate financial reporting.