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MIN, Han Ki, 1938-
A THEORETICAL AND EMPIRICAL INVESTIGATION
INTO PUBLICATION OF FORECASTS.

The University of Oklahoma, Ph.D., 1974
Accounting

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1974

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THE UNIVERSITY OF OKLAHOMA

GRADUATE COLLEGE

A THEORETICAL AND EMPIRICAL INVESTIGATION INTO PUBLICATION OF FORECASTS

A DISSERTATION

SUBMITTED TO THE GRADUATE FACULTY

in partial fulfillment of the requirements for the

degree of

DOCTOR OF PHILOSOPHY

BY

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Norman, Oklahoma

1974

A THEORETICAL AND EMPIRICAL INVESTIGATION

INTO PUBLICATION OF FORECASTS

APPROVED BY

DISSERTATION COMMITTEE

ACKNOWLEDGEMENTS

It is impossible to properly express the gratitude that is felt towards the individuals that have contributed to the completion of this dissertation. To the few mentioned here and the many who are not, I am sincerely grateful.

I am deeply indebted to Professor J. P. Klingstedt, who served as chairman of the dissertation committee. I also wish to thank the members of my dissertation committee, Professors Homer A Brown, Jr., T. P. Herrick, R. A. Ford, J. K. Stephens. Their criticisms were most constructive and helpful. It is doubtful that the study could have been completed had it not been for their help, patience and guidance.

A special note of thanks is due Professors T. P. Goggans and W. C. McGrew for their inspiration and guidance in the completion of my study. My sincere appreciation is also extended to Mr. M. B. Oien, my colleague, for his editorial comments.

Finally, a special debt of gratitude is owed to my wife, Chang Ja, and my parents. Their assistance and encouragement made it possible to attain a goal which at times appeared to be unattainable.

Although I received assistance from many persons, I alone accept full responsibility for all errors and misjudgement in this work.

ABSTRACT

Given the assumption that forecasts are prepared by corporate management, the present study investigated theoretically and empirically the following proposed question; "Is the publication of forecasts feasible?" Specifically, the present study focused on the following selected critical areas: (1) evaluation of the adequacy of current financial reporting practice; (2) identification of the major arguments both for and against the publication of forecasts; (3) investigation of the acceptable way of presenting forecasts for external reporting purposes; (4) examination of practicality of attestation to the published forecasts; and (5) examination of legal problems associated with the publication of forecasts.

Library research was done to identify and clarify theoretical aspects of the subject essential to the research. Conceptual attention was given to the primary purpose of financial reporting, the relationship between a share-price model and forecasts, and identification of conflicting viewpoints concerning the publication of forecasts. Also examined was the current practice of forecasts.

Then, the questionnaire was developed, tested, and mailed to the selected sample of the population. For this purpose, the population was defined as consisting of three groups: the management of the members of the Fortune 500 U.S. Largest Industrial Corporations, practicing CPAs and Chartered Financial Analysts. Seventy for each group was selected as a sample of each group.

The methods of data analyses consisted of three steps: (1) a test of the consensus among the three groups sampled by using Multivariate Analysis of Variance; (2) Principal Components Analysis to reduce the twelve arguments both for and against publication of forecasts into more important factors; and (3) tabulation of the answers to the returned questionnaires, with simultaneous interpretation in consultation with the relevant literature.

The results of the empirical investigation indicated that the three groups sampled in the current investigation did not have a meeting of minds as to the proposal for the publication of forecasts. Particularly the corporate

management were reluctant to publish forecasts to the public because they concerned with the criticisms by investors about the deviations of the published forecasts from actual results and because they believed that the publication of forecasts would create a competitive disadvantage. Excluding the extremes, the present study has drawn the following conclusions: First, the primary purpose of financial reporting is to provide investors, both present and potential, with sufficient and relevant information to facilitate investment decisions. Because investment decisions are based on future expectations, information about planned or expected operations of the company should be published as a part of financial reporting. Information about the past accomplishments of the company is also essential for eavluation of investment decisions. Because of many unresolved problems, the current practice of financial reporting based on historical-cost appeared to be refined to meet the primary purpose of financial reporting. Second, even though 75 percent of the respondents favored the permissible approach of the publication of forecasts, a substantial number of respondents felt that forecasts could not be meaningfully audited by a third party. Other than the inherent limitations of forecasts, lack of established standards appeared to be a major cause for disagreement shown by the respondents. Third, one strong argument against the publication of forecasts is that unless management (possibly an auditor when associated with forecasts) is given protection against the deviation of the publication of forecasts from actual results, exposure to legal liability would be increased. The pattern of the responses strengthened this argument. The legal liability thus appeared to be the most serious problem that has to be resolved before the implementation of the publication of forecasts.

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A THEORETICAL AND EMPIRICAL INVESTIGATION INTO PUBLICATION OF FORECASTS

CHAPTER I

INTRODUCTION

Statement of the Problem

Throughout history man has attempted to foresee what lies ahead of him. Although often hazardous, predictions seem to satisfy some inherent need in man for insight into the future. Making predictions about the future is a constant endeavor practiced by all businesses. Because planning for the future is an inevitable feature in today's business environment and because the business community is becoming increasingly dynamic, any attempt to reduce the uncertainty with respect to the future has become more necessary than ever before. The attempt to reduce the uncertainty with respect to the future in accounting is often termed financial forecasts. A financial forecast may be defined as the expression of expected or planned future transactions and events in quantitative terms which may or may not be realized.

Many writers have proposed that the primary purpose of financial reporting is to provide useful and

relevant information for making informed investment decisions.[1] A proposition generally accepted is that investors depend, to a great extent, on future expectations as a major aspect of investment decision-making. If these two propositions are valid, investors should use financial statements as a basis for predictions about the future. As Harvey E. Kapnick, Chairman of Arthur Andersen & Co., once put it, "an interest in every type of financial information about the future is understandable, since investors are more interested in the future--the uncertainty of the investment--than in the past performance."[2]

Investment process necessarily considers many elements of information. To be more meaningful, the necessary elements of information must be summarized and quantified. From the investor's viewpoint, the single most important question about a business enterprise is the future market price of the stock. Investment theory has long posited a relationship between earnings and the value of the stock. Since the value of a common stock is the present value of a company's future expected earnings,[3] published financial statements should help investors make informed judgments as to what the future earnings would be.

One of the significant criticisms about current financial reporting takes the form of a statement to the effect that financial statements do not provide statement users with "sufficient" and "relevant" information in

assessing a company's future prospects. The increasing number of investors, both individual and institutional, points to the need for published financial forecasts as additional information.

From the theoretical viewpoint, the publication of financial forecasts is desirable. Nonetheless, the publication of financial forecasts has not been accepted in the United States. This lack of acceptance is not because financial forecasts are irrelevant but because of the many practical difficulties involved in the implementation of the publication of forecasts. In recent years, however, there is some evidence of increasing demand for publication of forecasts.[4] Strong impetus was also given to an increased interest in the subject at the public hearings held before the Securities and Exchange Commission.[5] Whereas the demand for financial forecasts is evident, its extent is not. Furthermore, the likelihood that publication of forecasts may be broadened and effectively enforced has raised many questions. Efforts were thus necessary to determine the extent of demand for forecasts and to examine constraints in the implementation of publication of forecasts.

Need for the Study

The subject of publication of forecasts has received increasing attention in recent years. This increasing interest is evidenced by various articles in

accounting and financial literature. Yet, no comprehensive research study on the need for forecasts and practical problems involved in the publication of forecasts is available, except on a fragmentary basis.[6]

At present, considerable controversy exists as to the publication of forecasts. Many differing positions have been advanced as to the utility and practicality of publication of forecasts. One position contends that financial forecasts would be useful and relevant for making investment decisions and, in turn, publication should be implemented. On the contrary, another position argues that no publication of forecasts should be implemented on the grounds that the future events could not be predicted with the desired degree of reliability and that there would be many other problems involved in the implementation of publication of forecasts. Between these two extremes, another position argues for the necessity of an experimental stage before the publication of forecasts is required.

With the current widespread interest in equity investments, continuing demand for forecast information likely would exist. Despite the demand, no standard or guidelines have been set to be followed. As Morton Backer once said, "the development of meaningful accounting principles and procedures can be best accomplished through empirical research rather than reliance on inferential

logic."[7] Research is necessary in the area of financial forecasts to provide practical guidelines for determining the extent to which such information is in fact (1) needed by investors, (2) reliable for investment decisions, and (3) practically feasible for publication.

Purpose of the Study

Apparently no single study could attempt to cover all aspects of the subject under study. Certainly the present study does not attempt to do so. This does not mean that all areas, other than those lists for the present study as specified below, were totally ignored, but only that all other areas were discussed in a secondary priority.

An emphasis upon forecasts does not imply that forecasts are the only variable useful and relevant for the prediction of a company's performance. Forecasts may provide quantitative measure with respect to projected or planned operations and financial condition of a company. It is not possible to specify a complete model for forecasting a company's future expected earnings. Other factors such as timing preference and risk factors which investors should consider in making investment decisions are beyond the scope of the current investigation. The very important aspect of internal reporting to management is not intended to be covered in the present study. Finally, the question of "how to make a forecast" is also

outside the scope of the current investigation.

Given the assumption that forecasts are prepared by corporate management, the present study investigates theoretically and empirically the following proposed question: Is the publication of forecasts feasible? If the answer to this question is in the affirmative, additional investigation logically follows. Five selected areas for the present study are:

1. evaluation of the adequacy of current financial reporting practice;
2. identification of the major arguments involved with the publication of forecasts;
3. investigation of the acceptable way of presenting forecasts for external reporting purposes;
4. examination of practicality of attestation to the published forecasts; and
5. examination of legal problems to be associated with the publication of forecasts.

An investigation into the preceding five critical areas of the subject requires identification of the various conflicting viewpoints and the corresponding attitudes of the respondents participating in the current investigation. The present study collected and analyzed statistically empirical data for the purpose of testing the validity of the arguments advanced. To obtain a workable solution requires a balancing of the advantages and disadvantages

advanced by the differing groups. The research efforts will also make recommendations with respect to the establishment of standards from which practical guidelines for the implementation of publication of forecasts may follow.

Research Methodology

The present study is normative in the sense that it seeks what ought to be done. Research of this kind thus includes the development of theories, collection of empirical data, and testing the validity of the theories. The present study consists of three stages: (1) a review of literature, (2) collection of empirical data, and (3) analyses and interpretation of empirical data.

In an attempt to provide a conceptual basis for the entire study, the first source of information was collected through library research. This stage provides the background for present efforts.

The second stage of the investigation was a field survey of opinions. The empirical evidence was gathered through use of a questionnaire (see Appendix A for a copy of the questionnaire and accompanying cover letters) which was mailed to a selected corporate management, Certified Public Accountants, and Chartered Financial Analysts. The questionnaire consisted of five parts: (1) general, (2) advantages and disadvantages, (3) financial reporting, (4) attestation, and (5) legal implications. Statements included in both Part I and Part II of the

questionnaire were asked using a five point scale: strongly agree, agree, undecided, disagree and strongly disagree, so that data could be quantified for later statistical analyses. For the questions included in Parts III, IV, and V of the questionnaire the respondents were asked to indicate the best answer from several choices given on each question.

The questionnaire was sent to a randomly selected sample of the population. For the purpose of the current investigation, the population was defined as consisting of three groups: management of the Fortune 500 Largest U.S. Industrial corporations, practicing Certified Public Accountants listed in Accounting Firms and Practitioners: 1971, and Chartered Financial Analysts. Seventy were selected as the sample from each group.

The third stage of the present investigation was analyses and interpretation of empirical findings. This stage consisted of two parts: (1) statistical analyses and (2) descriptive statistics. The first part was a statistical analysis based on the results obtained from Parts I and II of the returned questionnaires. Multivariate Analysis of Variance was used to test consensus among the three groups. Principal components analysis was then employed to reduce the variables into more important factors for further study. The answers to the questions included in Parts III, IV and V of the questionnaires were

tabulated for the purpose of interpretation and analyses.

Organization of the Study

In order to place the subject in proper setting, Chapter II presents a brief discussion of the background of the subject. In the third chapter the current controversy and practice are discussed. The major arguments both for and against the publication of forecasts are evaluated and their implications to the current practice are also examined.

Chapter IV outlines the research methodology employed in data analyses. Chapters V and VI present the results of the empirical findings. Interpretation and analyses of the empirical data, together with the review of the relevant literature presented in Chapters II and III, lead to the conclusions of the current investigation, upon which the present study makes the recommendations in Chapter VII with respect to the publication of forecasts.

FOOTNOTES

[1]For example, see: Maurice Moonitz, The Basic Postulates of Accounting: Accounting Research Study No. 1 (New York: American Institute of Certified Public Accountants, 1961); American Accounting Association, A Statement of Basic Accounting Theory (Evanston, Illinois: American Accounting Association, 1968); Accounting Principles Board, Basic Concepts and Accounting Principles underlying Financial Statements of Business Enterprises: Statement of APB No. 4 (New York: A.I.C.P.A., 1970).

[2]Harvey E. Kapnick, "In the Matter of Estimates, Forecasts or Projections of Economic Performance (Chicago: Arthur Andersen & Company, 1972), p. 4.

[3]Eugene F. Fama and Morton H. Miller, The Theory of Finance (New York: Holt, Rinehart and Winston, 1972), p. 21.

[4]John C. Burton, "The Seaview Symposium on Financial Reporting," Journal of Accountancy (January, 1969), p. 37.

[5]Security and Exchange Commission, Security Exchange Act Release No. 9844: Commission Orders Proceedings in the Matter of Estimates, Forecasts or Projections of Economic Performance (Washington, D.C., November 1, 1972).

[6]For example, see: Financial Executive Institute, Disclosure of Business Forecasts (New York: Financial Executives Research Foundation, 1972); Financial Analysts Federation, Disclosure of Corporate Forecasts to the Investors (New York: Financial Analysts Federation, 1973); Richard Asebrook and D. R. Carmichael, "Reporting on Forecasts: A Survey of Attitudes," Journal of Accountancy (August, 1973); Robert A. Daily, "A Study of the Feasibility of Reporting Forecasted Information to Stockholders" (unpublished doctoral dissertation, University of North Carolina, Chapel Hill, N. C., 1970); Charles L. McDonald, "An Empirical Examination of Published Predictions of Future Earnings" (unpublished doctoral dissertation, Michigan State University, East Lansing, 1972).

[7]Morton Backer, "Financial Reporting and Investment Decisions," Financial Executive (December, 1966), p. 55.

CHAPTER II

BACKGROUND OF THE SUBJECT

Chapter II is presented primarily to place the subject in proper setting. It presents a brief review of the background of the subject. Then the primary objective of financial reporting is specified. Also, the evolutionary forces toward the publication of forecasts are examined.

Introduction to the Subject

Publicly-held corporations in the United States report more financial information about their operations than those of any other countries in the world. Nevertheless, there has been an increasing demand by investors, the Securities and Exchange Commission, and others, as well as accountants themselves, for additional information. In response to this demand, there have been, especially in recent years, many indications of trends toward improvements of corporate financial reporting. More research projects are being undertaken by professional organizations, academicians, and practitioners than ever before.

Although many improvements are being made in financial reporting, current practices are still being criticized. The basic criticism is that financial reporting of

today does not provide sufficient and relevant information for the needs of the statement users. Howard I. Ross, the past President of the Candian Institute of Chartered Accountants, made the following observation:

> More and more (or so it seems to me) people are going to other sources for financial information--to the president's report, or to the calculations of analysts--rather than to the conventional accounting statements we prepare for their guidance. My own conviction is that the dissatisfaction with current statements is general and serious, and that we can (and therefore should) do something about it.[1]

If the primary purpose of financial reporting is to provide investors with sufficient, relevant information needed for making rational economic decisions, and if this is not being done at present, a re-examination of current financial reporting would appear necessary. John C. Burton, the Chief Accountant of the Securities and Exchange Commission and the former Professor of Accounting at Columbia University, has said that:

> Within this environment it seems clear that improved communication is important in order to make the various interested parties aware of the problems of others and to see what steps might be taken to improve financial reporting where ncessary. In addition, the institutional environment concerning financial reporting requires continuing review to determine whether it can be made more effective both in dealing with the specific problems which arise from time to time and in developing a systematic and improving framework for corporate reporting.[2]

Sufficient and relevant information about a business enterprise should include financial information concerning the past, the present, and the future. Conventional financial statements show significant data of the past and

the present. This point is made clear in Paragraph 46 of the APB Opinion No. 9:

> Annual reports to stockholders are generally considered to be primarily historical in nature. . . . The main emphasis in the financial statements themselves has been on the results of the broad business activities of the entity during the current year as compared with those of the immediately preceding year.[3]

However, information about the future operations of the firm is not available from conventional financial statements. John C. Burton and Thomas Porter, Professos of Accounting at the University of Washington, made the following observation in connection with inadequacies in the current financial reporting:

> Financial statements purport to be useful in helping investors to make decisions about the commitments of assets to the corporation. Since the effectiveness of investment decisions depend upon the ability of the analyst to forecast the future effectively, the assumption implicit in this use of financial statements is that the past is a useful tool in forecasting the future. The same difficulties associated with the score-keeping function are of course part of the problems of using financial statements to forecast effectively. If management's decisions about the future do not represent a continuation of the actions of the past, forecasts arrived at from projections of conventional accounting events may occur which are not reflected in financial statements as conventionally presented until some later point in time. Accordingly, while financial statements do represent an input that may be useful in the forecasting process, they are far from comprehensive in this regard. Given these inadequacies in the current financial reporting, serious questions have arisen whether financial statements are sufficient for investors.[4]

Because investment decisions are based on future expectations, rather than past accomplishments, and because information about the future operations of the company is

the most important to investors in making their investment decisions, there has been an increasing demand by investors for forecast information.

The demand for information about the future operations of the company is not new. As early as in 1947, Stuart A. Rice, then Director of the Division of Statistical Standards, U.S. Bureau of Budgets, proposed that forecast (or budgeted) information be included in published financial statements. In a speech at the sixtieth annual meeting of the American Institute of Certified Public Accountants, Rice made the following statement:

> I should like to see business firms undertake to publish their budgets as well as financial statements because (1) it will give valuable information to stockholders and enable them to judge the planning ability of their managements and (2) provide valuable information on business plans and business operations for accountants and statisticians.[5]

Thus, he is credited as the first to introduce a proposal in the professional literature for inclusion of financial forecasts as an extension of financial reporting. Following his proposal, many academicians advanced the argument that budgetary disclosure is additional relevant information. Some of these proponents include Oswald Nielson,[6] Jacob G. Birnberg and Nicholas Dopuch,[7] and Yuji Ijiri.[8] More recently Sidney Davidson, Professor of Accounting at Stanford University, observed that "by the end of 1970's we can look forward to financial reports dealing with . . . future plans on a complete and formal basis with some type of attestation by the independent accountants."[9]

The subject of financial forecasts also attracted the practitioners' interest. For instance, in stressing the importance of forecast information, Howard I. Ross pointed out:

> . What has happened in the past is water over the dam, of no direct interest to anyone except an historian. . . . What most people really want to know is not what happened in the past, but what is going to happen in the future. Therefore, we might assume that our objective should be to devise a financial statement projecting what is going to happen next.[10]

Similarly, Joseph C. Roth, the past Chairman of the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, emphasized the usefulness of forecast information in investment decision-making, and predicted the publication of financial forecasts in the following manner:

> To deal with management first, the initial question will probably be, why publish forecasts? This idea is not original with me. Financial analysts, and other report users have been brought to the attention of the S.E.C. It is difficult to see how anyone could seriously question the usefulness of supplying information as to management's forecasts for the near future. Credit grantors and, perhaps, even to a great extent, investors and potential investors are interested in past financial results only as an indication of expected future performance. Granted that past results can be measured with some degree of accuracy, whereas projections are subject to considerable guesswork. Nevertheless, a reasonably reliable projection, in addition to and related to current actual results, can be most valuable in making investment decisions. The emerging generation, being better educated, more mature, and by and large disillusioned with traditional ways, is going to demand more and more information--and get it.[11]

From this review, the subject of forecasts is evidently attracting increasingly more interest in recent years.

Until 1970, however, the discussion of the proposal for publication of forecasts was limited to a proposal for and benefits of publication of financial forecasts. However, for the past three years, the subject has developed beyond the proposal stage. The subject has reached a stage to the necessity of determining a way to implement practically the publication of forecasts.

The Objective of Financial Reporting

Establishment of the objectives of financial reporting is essential if improvement is to be made in providing the statement users with improved financial reporting. Carl T. Devine made a succinct advocacy of stated objectives in a system of accounting theory as follows:

> The first order of business in constructing a theoretical system for a service function is to establish the purpose and the objectives of the function. The objectives and purposes may shift through time, but for any period they must be specified or specifiable. Once this first step is taken we have a framework that lets us investigate and conduct research in terms of carefully constructed objectives. When research is approached in this fashion, the objectives along with the usual logical apparatus become the deductive framework from which, by means of quantitative and behavioral relations, we may proceed to appraise the adequacy of the entire machinery of accounting and the consistency of its rules and procedure.[12]

Much has been discussed and written concerning the objectives of financial reporting. Both the American Accounting Association and the American Institute of Certified Public Accountants have issued statements on the objectives of financial statements. _A Statement of Basic_

Accounting Theory and Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises indicate that the basic objective of financial statements is to provide statement users with quantitative financial information relevant to decision-making. While this appears to be a logical starting point, it is too broad an approach to objectives of financial reporting. Since financial reporting should be designed to convey information to the statement users for their needs, the following questions must be answered before the objectives of financial reporting can be specified:

1. To whom is financial reporting directed?
2. What are economic problems of the statement users?
3. What information is needed to resolve these problems and what data generated by the accounting system will meet this need?

The Primary User of Financial Statements

Financial statements are used as a basis for decision-making by various groups. Therefore, the objectives of financial reporting can be satisfactorily defined only by reference to the objectives of these groups and the nature of their decisions based on financial information.

The Committee to Prepare A Statement of Basic Accounting Theory of the American Accounting Association defines the users of financial statements:

> External users include present and potential investors, creditors, employees, stock exchanges, government units, customers, and others. Representatives of these users, such as security analysts, trade associations, credit rating bureaus and trade union officers are also included.[13]

Thus, the Committee advocates the general purpose financial statements. Indeed, investors, both present and potential, creditors, government, all use financial statements to some extent. For the most part, however, these groups have different information needs. Information of particular interest to one group may be of little interest to another. Therefore, the general purpose statements are difficult to implement. They are unattainable if general purpose statements are intended to meet the needs of all these groups. The needs of various groups are difficult to identify. Within the framework of a single general purpose report, the interests of all the groups may not be possible to satisfy. The Committee on Corporate Financial Reporting of the American Accounting Association reported that "it is impossible to design a general purpose report that is of universal relevance and provides optimal information for all conceivable users."[14] To the extent interests coincide, a general purpose statement is possible. If the interests and the resultant informational needs conflict, a selection of the primary user must be made.

The problem can then be reduced to identifying the primary user of financial statements. Even so, who is the dominant group in the use of financial statements?

In defining the users of financial statements, the Study Group on the Objectives of Financial statements has said:

> Some users of financial statements can obtain more information about an enterprise than others can. This is clearly so for managers, but it also holds true for others, such as large-scale equity investors and creditors. . . . Financial statements are, accordingly, especially important to those who have limited access to information and limited ability to interpret it. Therefore, users who ordinarily rely on financial statements alone may be served most by developing accounting objectives.[15]

While more important users of financial statements may be classified into investors, creditors and managers, managers of the business enterprise often have access to much more information than outsiders. This also holds true for creditors because they can request more information than is available to the users of general purpose financial statements. Therefore, "those users who have limited access to information and limited ability to intepret it" may be understood as the general investors.

Today, a large portion of business activities is conducted by corporations whose financial resources are publicly financed. Most of the shareholders of these corporations are not active in the business, and are relatively unsophisticated. They need basic information concerning the financial strength and operations of the business, the ability to continue to make earnings, and its growth potential. Then these public investors that have interests in the affairs of a corporation have need for financial

reporting. Simply stated, the primary user of financial statements should be investors, both present and potential.

Economic Problems of the Statement User

Performance measurement or evaluation is an all pervasive aspect of our society. Accounting is not an exception. Financial accounting, then, must have some knowledge of the environment within which those being evaluated must operate, or in the absence of such knowledge, it must make some assumptions about the environment. The accountant has assumed that the appropriate environment is the one described by economists as the "market system" and that the appropriate behavior coincides with that of "wealth maximizer." Thus, the basic concern of financial reporting is to measure performance according to the basic direction toward a business entity.

Any economic or social system has the same problem, that is, with given and limited economic resources how can these resources be combined in order to obtain the maximum output? In a market or competitive economy, there is, in general, a three-fold problem of resource allocation, namely, (1) interindustry allocation, (2) interfirm allocation, and (3) intrafirm allocation of a particular business entity. The allocation of resources thus involves competition for the scarce resources available. Therefore, an investor's economic problem becomes the discovery of the best investment choice with given economic resources.

The investor thus needs sufficient and relevant information in making and evaluating investment decisions. As Maurice Moonitz, Professor of Accounting at the University of California, postulates, financial statements should be useful because "quantitative data are helpful in making rational economic decisions, i.e., in making choices among alternatives so that actions are correctly related to consequences."[16]

Informational Requirement

If an investor needs sufficient and relevant information in order to achieve rational economic decisions, what information does he consider relevant for making his investment decisions? Thomas R. Dyckman, Professor of Accounting at Cornell University, states that:

> The information requirement specified above implies the need for a communication network through which insight might be attained on the value of various investment opportunities. Such an information system must supply relevant data which will facilitate the investment decisions. This is, or ought to be, a basic purpose of financial reporting. Financial reporting, then, must generate quantifiable data which will assist in making rational investment decisions.[17]

The objective of an investor is usually to commit economic resources to the investment opportunity with the expectation of receiving a larger amount of returns in the future within a given risk constraint. Generally, an investor evaluates investment opportunities in terms of risk and return on investment. A good investment opportunity may be defined as one which offers a maximum return for

a given risk or a minimum risk for a given return. These two elements affect investment decisions of an investor. He seeks financial information which will assist in determining or estimating these two elements.

Accountants have based their selection and reporting criteria on several assumptions. Some of these assumptions are (1) information on past events is a valid predictor of future events in most instances and (2) past market exchanges are common to all firms and provide reliable evidence of the change in the money value of resources. Thus, much of the current financial reporting is concerned with the reporting of past events and actions so that actual developments can be compared with some standards for the acceptability or nonacceptability of the actions.

The current practice of financial reporting attempts to show (apart from the problems of valuation) the effect of management's decisions on the company's resources as accomplished through completed transactions. There is no doubt that this information is useful for tracing trends. Information about the past is useful to the extent in helping investors make decisions about an uncertain future.

Accountants recognize that events, other than past exchanges, are important, but the conventional approach has been that the desire for objective evidence necessitates that those events, other than completed transactions, should either not be reported or should not be considered

a part of information for financial reporting.

Nevertheless, an investor seeks financial information not only in evaluating the company's ability to manage its resources, as it did in the past, but also in estimating future earnings and growth potential of the company. He thus needs more than historical information about the results of the company's operations. As stated in the preceding section, conventional statements do not, however, include information about planned or expected operations of the company.

If the primary objective of financial reporting is to supply sufficient and relevant information to facilitate investment decisions, information requirement should include not only historical information but also information about expected or planned operations of the company.

Evolutionary Forces Toward Publication of Financial Forecasts

If the primary objective of financial reporting is to supply investors with sufficient and relevant information to facilitate investment decisions, a question arises as to whether the current practice of financial reporting meet its objective?

The Study Group on the Objectives of Financial Statements suggested the following as some of the more severe criticisms on the practice of financial accounting:

1. Accountants have considered themselves primarily historians, not prophets. Financial statements

have reported on past performance, but not explicitly on future prospects. However, even present accounting principles require estimates of the future. For instance, the amounts shown for assets in balance sheets imply that enterprises will recover at least these amounts from their future use or sale. Considerable current debate centers on inclusion of explicit predictions of a broader nature in financial reports.

2. Accounting measures generally have been based on the results of exchange transactions. Historical costs of resources and obligations only coincidently reflect their current values. Those who advocate current values suggest that accounting should not be restricted to values based only on these past exchange transactions.

3. Accounting frequently involves choices among alternative methods. When like things are not reported alike, users of financial statements have difficulty comparing competing economic opportunities. Moreover, it is suggested that the selection of accounting alternatives has sometimes been made in an attempt to influence reported earnings rather than to reflect actual economic change. Although no accounting structure can be designed which eliminates all reasonable alternative methods for treating like circumstances, it is argued that comparability should be the overriding consideration for choosing among methods.

4. Accounting has emphasized general purpose financial statements. But it is claimed that various users require different kinds of financial statements to satisfy their various needs.

5. In the basic financial statements now prepared, key amounts in one statement relate directly to amounts in other statements. Statements related in this way are said to articulate--a requirement considered by some to be unduly restrictive. They claim that independent or unrelated representations in statements would increase their usefulness.

6. Assertions have been made that present financial statements do not provide sufficient information about the liquidity and cash flows of an enterprise.

7. Changes in purchasing power of the monetary unit have been substantial, and it is claimed that these changes should be recorded formally in financial statements.

8. Materiality has long been integral to financial reporting. But there are some who question whether this concept is defined and communicated adequately to prevent its misuse.[18]

Indeed, there are many problems unsolved in current financial reporting. Questions have been raised concerning the delineation of the objective of financial statements. The relevance and sufficiency of information have been challenged. The users have also complained that because of lack of agreement regarding measurement of income and asset valuation there are too many acceptable alternative reporting procedures so that like transactions can be handled a number of ways. Because of these unresolved problems, agreement is that the past-oriented information does not provide a useful basis for an extrapolation into the future.

There are many factors responsible for these unresolved problems. For one thing, there has been no clear statement of the objective of financial reporting, nor have there been any theoretically sound formulations of financial accounting theory.

Dissatisfaction with the Committee on Accounting Procedure led to the formation of the Accounting Principles Board in 1959. When the Accounting Principles Board was created, research was seen as the foundation upon which definitely needed new principles would be established. Emphasis was given to the reexamination of objectives and proposed broad principles of financial accounting.

Unfortunately, research was slow, and the research results were almost purely theoretical in nature with less practical applicability. In the meantime, however, the Board was faced with many problems such as the investment tax credit, extraordinary items, earnings per share, cost of pension plans, business combinations and many others. Because of these problems at hand, the Board abandoned the search for the basic principles underlying financial reporting, and it was forced to expand efforts toward establishing detailed arbitrary rules to meet pragmatic day-to-day reporting problems.

Although the Board made some significant progress in financial reporting by reducing the number of alternatives and establishing uniform guidelines, many opinions that the Board released had no sound rationale or basic principles applied uniformly to all of them. Consequently, reliance of investors on corporate reports for investment decisions have been diminished, and the criticisms of the current financial reporting have mounted.

In response to the mounting criticisms, the first joint meeting of four professional organizations interested in financial reporting--American Institute of Certified Public Accountants, Financial Analysts Federation, Financial Executives Institute and Robert Morris Associates--met together in early November, 1968. The Symposium set a landmark in bringing together for the first time representatives

of the four leading professional organizations in the financial field on a subject of common interest.

Subjects explored by the participants were closely related to the preparation and use of financial information. Besides the question of independence, the Symposium brought three differences in the thinking of varying professions to focus on (1) objectives of reporting, (2) comparability and flexibility and (3) information on budgets. Apparently, users and preparers in the Symposium did not have a meeting of minds on the objectives of financial statements. To the user, as Robert T. Sprouse, Professor of Accounting at Stanford University, put it, "the purpose of financial statements is to provide information which is useful in making rational economic decisions,"[19] and a major use lies in making equity investment decisions. To preparers, "the primary purpose of corporate financial statements is to discharge management's obligation to report to its shareholders on its stewardship and to society on the progress of business."[20] The CPAs seemed to concur with management by asserting that reporting is management's obligation, and auditors are only attesting to the reports. Many financial analysts that participated in the Symposium have also urged greater uniformity in accounting methods in order to permit greater comparability as between the statements of different companies.

The most significant new idea discussed at the

Symposium was the proposal that corporations disclose future plans and expectations. In the Summary Report of the 1968 Symposium, John C. Burton stated:

> The analysts pointed out that investors are most interested in what will happen and use past data to help in predicting the future. Since management is most sophisticated in applying forecasting techniques and is most knowledgeable in respect to the factors which would affect the business, its expectations would be more likely to be accurate than the guesses of outsiders. In addition, it was pointed out that substantial sums were being spent on forecasting by management and that virtually all management information system today included long range plans and budgets which were used for the internal purposes of the firm. Without being specific as to what data were desired, the analysts pressed for disclosure of such future-oriented information.[21]

Three years later, in November, 1971, leading members of the American Institute of Certified Public Accountants, the Financial Analysts Federation, the Financial Executives Institute, and Robert Morris Associates met again. Also present were representatives of the Securities and Exchange Commission, New York Stock Exchange and the legal profession. The subjects discussed at this meeting were ethics in reporting and new ideas for the improved performance of the reporting process.

The subject of forecasts was again the topic for further discussion at this meeting. At the first Symposium there seemed to be general distrust of the proposal for publication of forecasts. However, in the intervening three years the interest in the forecasts had significantly increased. The proposal for disclosure of corporate

forecasts was crystalized at the second Symposium. John C. Burton reported that:

> This topic had been discussed at the first Seaview Symposium and at that time there seemed general distrust of the whole idea. In three years a significant change in viewpoint could be detected. Among the participants, the analysts seemed generally in agreement that public forecasting was an idea whose time had come, while corporate executives, although not agreeing that regular published forecasts were the right answer, did concur that financial management had a responsibility to avoid surprises and that the publication of explicit forecasts was one of the ways of meeting this responsibility. Several executives, however, preferred the approach of giving assistance to analysts so that their forecasts were not too far away from reality as currently perceived by the corporation.[22]

A broad consensus emerged from the second Symposium that the corporate forecasting was the most significant current issue in corporate disclosure to the investors. Discussion at the second Symposium was more concerned with the problems involved in implementing the publication of forecasts such as the role of forecasts in financial reporting, informational content, potential legal liabilities and the possible role of the auditor associated with financial forecasts. Thus, the question was how to implement publication of forecasts. Although there was no general agreement reached at this meeting, the subject was discussed in more details than at the first Symposium, and there appeared to be a tendency toward more participants being in favor of publication of forecasts.

The year 1971 can be considered an important turning point in financial reporting in that the Study Group

on the Objectives of Financial Statements was established by the American Institute of Certified Public Accountants. Marshall Armstrong, then the President of the AICPA, called a conference of thirty-five prominent CPAs from twenty-one major accounting firms in early 1971. In light of the mounting criticisms and the significant problems in financial reporting, the main objective of this conference was to re-examine the current practice of financial reporting. Indeed, the criticisms of the activities of the AICPA increased to a point where a review of the entire situation appeared to be desirable. The conference also attempted to determine which were the major issues and questions in any study of the establishment of accounting principles and to explore various alternatives to this study. The conference appointed two groups. One was directed to review the operations of the Accounting Principles Board, and the other was to define the objectives of financial statements.

With this background, the Study Group on the Objectives of Financial Statements was established in 1971, and began its work under a charter which begins: "The main purpose of the study is to refine the objectives of financial statements. Refined objectives should facilitate establishment of guidelines and criteria for improving accounting and financial reporting."[23] In seeking to refine the objectives of financial statements, the Study Group considered the following questions:

1. Who needs financial statements?

2. What information do they need?

3. How much of the needed information can be provided by accounting?

4. What framework is required to provide the needed information?[24]

Thus, the Study Group attempted to identify specific problems and issues which will be responsive to the needs of those who rely on the present financial statements. The Study Group considered, for example, the applicability of historical costs, current values, private and social costs and benefits, and forecasting and budgeting. Most significant was its consideration of the possible need for forecasts and budgets as part of the basic financial reporting and the possible utilization of different forms of appropriate attestation.

In view of the increasing interest in the forecasts and because of its importance to investors, the Securities and Exchange Commission took the initiative on the subject. On November 1, 1972, the Commission announced the public hearings on the "Disclosure of Projections of Future Economic Performance" in order to gather pertinent information. The public hearings were held from November 20, 1972, through December 12, 1972. The purpose of the public hearings was to attempt gathering the following information:

1. Whether such estimates, forecasts or projections should be required, merely permitted, or prohibited in whole or in part in filing with the Commission,

or whether any requirements should apply to certain classes of issuers;

2. Which types of filings under the Securities Act of 1933 and the Securities Exchange Act of 1934 should be allowed, or be required, to contain such estimates, forecasts or projections, if any and whether followup should be required;

3. Whether guidelines or rules should be adopted relating to estimates, forecasts or projections which are disseminated to the public through the communication media by companies whose securities are publicly traded;

4. Whether standard assumptions underlying such estimates, forecasts or projections are feasible, and if so, what types of assumptions are necessary;

5. What format for presentation should be required;

6. Whether certification or some other form of independent verification or report on such estimates, forecasts or projections should be required, and if so, in what form and whether standards for qualification persons certifying or verifying or reporting on such estimates, forecasts or projections should be adopted; and

7. The effect of the civil and criminal liability provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 on estimates, forecasts or projections filed with the Commission.[25]

The Division of the Corporate Finance of the Commission conducted the public hearings. The principal organizations testified before the public hearings were the American Bar Association, the American Institute of Certified Public Accountants, Financial Analysts Federation, the Financial Executives Institute, the National Investors Relations Institute, National Association of Accountants, New York Stock Exchange, and Securities Industry Association. In addition, seven listed corporations,

nine investment banking and brokerage firms and seven major accounting firms testified. The Division also received over two hundred written statements from persons who did not appear at the hearings.

Significance is that the public hearings brought many interested people together publicly and that the subject was discussed officially for the first time. Although there was no agreement reached on the subject at the public hearings, information gathered at the public hearings indicated that

> management's assessment of a company's future performance is information of significant importance to the investors, that such assessment should be able to be understood in light of the assumptions made, and that such information should be available, if at all, on an equitable basis to all investors.[26]

The hearings also revealed widespread dissatisfaction with the fact that there are today no guidelines or standards that the issuer, the financial analyst or the investor can rely on in issuing or interpreting projections (refer to Chapter III for the present position of the Securities and Exchange Commission).

Summary

Although many improvements are being made in financial reporting, current practices are still being criticized. The basic criticism is that financial reporting of today does not provide sufficient and relevant information for the needs of the statement users. Sufficient and relevant

information about a business enterprise should include financial information concerning the past, present, and future. Conventional financial statements show significant data of the past and the present, but information about planned or expected operations of the company is not available from conventional statements. Because investment decisions are based on future expectations, rather than past accomplishments, and because forecast information is the most important to investors in making investment decisions, there has been an increasing demand for forecast information.

The demand for forecast information is not new. As early as 1947, Stuart A. Rice proposed to include forecast information in the financial statements. Following his proposal, many academicians and practitioners advanced the argument that disclosure of corporate forecasts is additional information relevant for making investment decisions. Until 1970, the discussion of the subject was limited to a proposal for and benefits of publication of forecasts. However, for the past three years, the subject has developed beyond the proposal stage. The subject has reached to a stage to the necessity of determining a way to implement practically the publication of forecasts.

The primary objective of financial reporting has been defined as one supplying investors with sufficient and relevant information to facilitate investment decisions.

Severe criticisms prevail that current practice of financial reporting does not meet its objective for the needs of the statement users. In response to mounting criticisms, the first joint meeting of four professional organizations interested in financial reporting--American Institute of Certified Public Accountants, Financial Analysts Federation, Financial Executives Institute and Robert Morris Associates--was held in November, 1968. In that Symposium, the subject of forecasts was discussed by the participants as the most significant new idea in financial reporting. The subject of forecasts was again the topic for further discussion at the second Symposium held in November, 1971. The Study Group on the Objectives of Financial Statements also considered the possible need for forecasts as part of the basic financial reporting and the possible utilization of different forms of appropriate attestation.

In view of the increasing interests in forecasts and because of its importance to investors, the Securities and Exchange Commission held public hearings on the subject. Although there was no agreement reached on the subject at the public hearings, indications were that management's assessment of a company's future performance is information of significant importance to investors and that such information should be available on an equitable basis to all investors. The hearings also revealed widespread dissatisfaction because no standards or guidelines

have been available to be followed and that there are many conflicting viewpoints with regard to the problems of implementing the publication of forecasts.

FOOTNOTES

[1]Howard I. Ross, "The Current Crisis in Financial Reporting," Journal of Accountancy (August, 1967), p. 66.

[2]John C. Burton, Corporate Financial Reporting: Conflicts and Challenges (New York: The American Institute of Certified Public Accountants, 1969), p. 2.

[3]Accounting Principles Board of the A.I.C.P.A., Opinions of the Accounting Principles Board No. 9: Reporting Results of Operations (New York: The American Institute of Certified Public Accountants, 1966).

[4]Thomas Porter and John C. Burton, Auditing: A Conceptual Approach (Belmont, Calif.: Wadsworth Publishing Co., Inc., 1971), p. 509.

[5]Stuart A. Rice, "Use of Accounting Data in Economics and Statistics," Challenges to the Accounting Profession, 1947, Papers Presented at the 60th Annual Meeting of the American Institute of Accountants, November 3-6, 1947, Miami Beach, Florida (New York: The American Institute of Accountants, 1947), pp. 25-26.

[6]Oswald Nielson, "New Challenges in Accounting," Accounting Review (October, 1960), pp. 583-589.

[7]Jacob G. Birnberg and Nicholas Dopuch, "A Conceptual Approach to the Framework for Disclosure," Journal of Accountancy (February, 1963), pp. 38-63.

[8]Yuji Ijiri, "On the Budgeting Principles and Budget-Auditing Standards," Accounting Review (October, 1968), pp. 662-667.

[9]Sidney Davidson, "Accounting and Financial Reporting in the Seventies," Journal of Accountancy (November, 1969), p. 37.

[10]Howard I. Ross, op. cit., p. 68.

[11]Joseph C. Roth, "The Role of the Auditor," Corporate Financial Reporting: Conflicts and Challenges, ed. by John C. Burton (New York: American Institute of Certified Public Accountants, 1969), p. 256.

[12]Carl T. Devine, "Research Methodology and Accounting Theory Foundation," *Accounting Review* (July, 1960), p. 399.

[13]American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston, Ill.: American Accounting Association, 1966), p. 20.

[14]Committee on Corporate Financial Reporting of the American Accounting Association, *Report of the Committee on Corporate Financial Reporting*, Supplement to Accounting Review (1972), p. 526.

[15]The Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements* (New York: American Institute of Certified Public Accountants, 1973), p. 17.

[16]Maurice Moonitz, *The Basic Postulates of Accounting: Accounting Research Study No. 1* (New York: American Institute of Certified Public Accountants, 1961), p. 21.

[17]Thomas R. Dyckman, "On the Investment Decisions," *Accounting Review* (April, 1964), p. 285.

[18]Study Group on the Objectives of Financial Statements, *Objectives of Financial Statements*, *op. cit.*, pp. 15-16.

[19]John C. Burton, *Corporate Financial Reporting: Conflicts and Challenges*, *op. cit.*, p. 201.

[20]*Ibid.*

[21]John C. Burton, "The Seaview Symposium on Financial Reporting," *Journal of Accountancy* (January, 1969), p. 37.

[22]John C. Burton, "Symposium on Ethics in Corporate Financial Reporting," *Journal of Accountancy* (January, 1972), p. 46.

[23]The Board of Directors of the American Institute of Certified Public Accountants, "A Study of the Objectives of Financial Statements," *Objectives of Financial Statements* (New York: American Institute of Certified Public Accountants, 1973).

[24]*Ibid.*

[25]Securities and Exchange Commission, *Securities Exchange Act of 1934 Release No. 9844: Commission Orders Public Proceedings in the Matter of Estimates, Forecasts or Projections of Economic Performance and Related Subjects* (Washington, D.C., November 1, 1972).

[26]Securities and Exchange Commission, *Securities Act of 1933 and Securities Exchange Act of 1934: Statement by the Commission on the Disclosure of Projections of Future Economic Performance* (Washington, D.C., February 2, 1973).

CHAPTER III

CURRENT CONTROVERSY AND PRACTICE

Introduction

This chapter presents a definition of financial forecasts and a review of current controversy on the subject. The discussion of the current controversy concerns the relationship between a share-price model and forecasts, and identification of conflicting viewpoints on the publication of forecasts. This chapter also presents the review of current practice which includes the review of the positions taken by the American Institute of Certified Public Accountants, the American Accounting Association and the Securities and Exchange Commission, the review of the British experience in forecasts, and the review of current forecast practice in this country.

Definition of Financial Forecasts

In connection with the need for a specific definition of financial forecasts, Harvey E. Kapnick made the following observation:

> First of all, we need a better definition and understanding of just what we are talking about. Forecasts, projections, goals, budgets, targets, performance standards and other similar nomenclature is often used interchangeably when in the mind of preparer or the

> user each may have distinctly different meanings and purposes. . . . These differences are subtle, but nevertheless, they are real. Until a clear understanding can be reached both as to which of them is most useful to the investor, it is probable that wide dissemination of any of these types of forecasts may not be helpful and may be misleading.[1]

There is no generally agreed upon definition of financial forecasts. Many different definitions are found in the literature and are used in practice. However, each definition is different in meaning. For instance, the Securities and Exchange Commission used the term "Estimates, Forecasts, or Projections of Economic Performance" in its announcement to the public hearings on the subject of forecasts. R. Gene Brown, the Vice President of Syntex Corporation, defined financial forecasts as:

> Any published quantitative or nonquantitative statement which provides direct information about the entity's expected future performance, or data complementary to historical financial statements in such sufficient detail as to permit interested parties external to the firm to make their own reasonably reliable financial projections.[2]

W. W. Cooper, et al., adopted the term budgetary disclosure in which budgetary disclosure refers to: "(1) the published projections of the next period's balance sheet, income and funds flow statements and (2) its critical comparison with actual results in a stockholders' report at the end of each year."[3] At the SEC public hearings the American Institute of Certified Public Accountants referred to the financial forecasts as "financial summaries of the best possible estimates of future expectations."[4]

As noted from the above definitions, the term financial forecasts is being applied to data which can take many forms and details, ranging from a simple qualitative comment to a detailed financial projection in the form of an income statement and balance sheet, as well as a statement of changes in financial position. The terms "budgets" and "forecasts" are often used interchangeably. Although budgets may be defined as "inflated management goals in order to take advantage of motivational aspect,"[5] forecasts may be defined as expected or planned future events and transactions of the company.

Defining what constitutes financial forecasts is necessary to avoid any ambiguity or misunderstandings. For the present study financial forecasts of a company are defined as

> quantified financial information, published for external users, of the future expected or planned events and transactions which are most likely to occur for the coming year.

Qualitative expressions such as "a good year" or "better than last year" would not constitute financial forecasts for the purposes of the discussion in the current investigation. Also excluded are the inflated management goals which might possibly differ in amount from forecasts as defined above.

Current Controversy

Relationship between Financial Forecasts and a Share-Price

From the investor's viewpoint, the most important question about a business enterprise is: What will the future market price of the stock of the corporation be?

A theory of finance argues that future earnings and/or dividends of a corporation determine the price of a common stock, but there is some disagreement about whether earnings or dividends are the most relevant factors. For example, Myron J. Gordon, Professor of Finance at the University of Rochester, argues that the price of a stock is the present value of the future expected dividend streams.[6] On the other hand, Franco Modigliani and Morton H. Miller propose that the price of a share is a function of the future expected earnings.[7] Not yet resolved is whether future dividends or future earnings are the primary factor in determining the price of a share. This question is not, however, important because earnings and dividends are closely related.[8] If the position is taken that a share price is the present value of future expected earnings, it can be expressed as

$$PV = \sum_{t=0}^{\infty} \frac{E_t}{(1+k)^t}$$

In this formula, PV equals the present value of the stock, E_t equals expected future earnings at time t, k equals capitalization rate and t equals the time. The price of

a share is then a function of future expected earnings of the firm. Therefore, if earnings rise, the price of the stock should rise, and, conversely, if earnings fall, the price of the stock should fall.

In the long-run, the theoretical value of a stock is a function of current and expected future earnings discounted at some rate of interest. Under conditions of certainty, the value of a stock is simply the sum of the present value of future earnings capitalized at a riskless rate. When the simplifying assumption of perfect certainty is removed, a share price model becomes complicated because an element of uncertainty enters into the model. Evaluation of investment decisions under uncertainty thus requires (1) estimating the amount of expected future earnings and (2) choosing an appropriate discount rate. Once these two elements have been established, the present value of a stock is a matter of mathematical calculations. However, these two elements usually cannot be readily determined. Cottle and Whitman suggest that the valuation of a corporation's stock would be more accurate if it were derived from a satisfactory forecast of the earnings power of the enterprise as a whole.[9]

Since the future market price of a stock is a function of future expected earnings, an investor attempts to predict expected future earnings of the company under a given set of assumptions to estimate the price potential

of the stock. Because the future is uncertain, an investor seeks financial information to reduce the degree of uncertainty. R. Gene Brown observed that an investor is interested in financial forecasts because information about the present and future income and dividend flows is surrogate to the future stock price.[10]

If the relationship between a share-price and forecasts is as such, publication of forecasts can be argued on the following proposition: Investment decisions are based on future expectations; therefore, information about planned or expected future operations of the company is important and relevant to the investor.

Arguments against Publication of Financial Forecasts

As noted from the relationship between a share-price and forecasts, the publication of forecasts is desirable from the theoretical viewpoint. Nonetheless, the publication of forecasts has not been accepted in the United States. This is not because forecasts are irrelevant but because there are many practical difficulties in the implementation of the publication of forecasts. Presently, a considerable amount of controversy exists as to practical difficulties in the implementation of the publication of forecasts. The major arguments against the publication of forecasts are:

1. If forecasts are required to be published, investors

may not recognize inherent limitations of forecasts. Investors would accept the published forecasts at their face value, and would place undue reliance on them.

2. If forecasts are required to be published, forecast information could be advantageous to knowledgeable competitors, and could be detrimental to a firm's competitive position.

3. Management must account for any failure to meet the published forecasts which are uncertain at the outset. Unless management (possibly an auditor when associated with forecasts) is given protection against material deviations of the published forecasts from actual results, exposure to legal liability could be increased.

4. The general tendency of management may be to make conservative forecasts, and, in turn, avoid taking proper business risks.

5. Management could deliberately manipulate the published forecasts to realize desired results, and there would be some possible dangers of market manipulation by publishing overstated forecasts.

6. Preparing, revising, and auditing published forecasts would be the incremental costs.

7. A general loss of confidence in financial reporting would be likely. Most investors are unsophisticated and might interpret the published forecasts as indicating definite assurance about the future. If published

forecasts would deviate from actual developments beyond the acceptable degree of reliability, investors would question the credibility of financial statements as to forecasts and historical statements.[11]

Arguments for Publication of Financial Forecasts

1. The most important argument in support of the publication of forecasts is that expected future earnings are of prime importance to investors. Since investment decisions are based on future expected earnings, the price of a stock reflects future earnings expectations. Because of the uncertainty involved, forecasts that indicate future earnings would reduce the degree of uncertainty. While historical information could improve the predictive power, it is no substitute for forecasts.
2. Because of many unresolved problems in current practice of financial reporting such as the valuation problems and alternative practices, historical information does not provide a useful basis for prediction.
3. Forecasts are currently prepared, disseminated, and used in an unregulated way. Only some corporations participate, however, and only some investors have access to the information. Required forecasting would thus assure uniform practices and equalize investor access to the information.[12]
4. Forecast information is useful not only in making

investment decisions by investors, but also in providing investors with a basis for evaluating management performance. Forecasts provide both a decision environment and standard for evaluation of management performance. When actual results are compared with the published forecasts, the investor can evaluate management's planning ability and performance.

5. Forecasts prepared by management would be more meaningful than those prepared by financial analysts because management possesses more detailed information about planned future operations of the company and the internal operations. In addition, forecasts prepared by management would accompany detailed assumptions prepared by management and therefore are more meaningful than forecasts prepared by financial analysts which could not have detailed assumptions as to the internal operations of the company.

6. Whenever investment decisions are based on inadequate information, decision-makers face the possibility of allocating their economic resources in less-than-optimum investment decisions that lead to a less than optimum allocation of economic resources. Given more relevant information of forecasts, one can expect more scientific investment analysis, and use of forecasts by investors encourages efficient resource allocation.

Review of Current Practice

This section presents the positions taken by the American Institute of Certified Public Accountants, the American Accounting Association and the Securities and Exchange Commission on the publication of forecasts. A review of the British experience in forecasts and the current forecast reporting practice in this country are also presented.

Positions taken by AICPA, AAA, and SEC

American Institute of Certified Public Accountants

The long standing position of the Institute is that it is improper for an accountant to certify statements of future earnings of his clients. The Institute adopted the rule relating to certification of forecasts as early as 1931.[13] In that year, the Committee on Professional Ethics drafted a proposed rule that prohibits a member from certifying an estimate of earnings contingent upon future transactions. In April, 1932, the Council of the American Institute of Accountants adopted the following resolution:

> WHEREAS, Estimates of earnings contingent upon future transactions should always be clearly distinguished from statements of actual earnings evidenced by definite records, and
> WHEREAS, An accountant may properly assist a client in estimating the results of future transactions, so long as no one may be led to believe that the estimates represent certainties,
> BE IT RESOLVED, That no public accountant should permit his name to be used in conjunction with such an

> estimate in a manner which might lead anyone to believe that the accountant could vouch for the accuracy of the forecasts.[14]

This resolution became the forerunner of the Rule 204 of the Code of Professional Ethics. The above resolution on earnings estimates was initially approved as a formal rule and became effective in 1941. In December, 1960, the Committee on Professional Ethics issued Opinion No. 10, entitled "Responsibility of Member for Pro Forma Statements and Forecasts under Rule 204." The rule was modified in 1964 and again restated in 1973.

Effective March 1, 1973, Rule 204 of the Code of the Professional Ethics was restated to read:

> A member shall not permit his name to be used in conjunction with any forecast of future transactions in a manner which may lead to the belief that the member vouches for the achievability of the forecast.[15]

Interpretation of the Rule 204 provides that:

> Rule 204 does not prohibit a member from preparing, or assisting a client in the preparation of, forecasts of the results of future transactions. When a member's name is associated with such forecasts, there shall be the presumption that such data may be used by parties other than the client. Therefore, full disclosure must be made of the sources of the information used and the major assumptions made in the preparation of the statements and analyses, and the degree of the responsibility he is taking.[16]

The Code permits accountants to prepare forecasts for a client but, at the same time, warns that any member shall be prohibited from vouching for the accuracy of forecasts. Thus, the Code of Professional Ethics Rule 204 and its interpretation have been the reflection of the position

taken by the AICPA.

American Accounting Association

The American Accounting Association has been developing and improving corporate reporting standards since its inception in 1918. The Association published a most comprehensive report on accounting theory in 1966, entitled A Statement of Basic Accounting Theory which indirectly relates to the subject of forecasts.

The Committee to Prepare A Statement of Basic Accounting Theory presents the following argument in connection with accounting information for external users:

> Many persons use accounting information as an aid to some kind of prediction. . . . It is important to emphasize that accountants (with good justification) have avoided to emphasize the role of forecasters in connection with reports to external users. The Committee suggests that accounting information for external users should reflect their needs by reporting measurements and formulations thought to be relevant in the making of forecasts without implying that the information supplied is wholly adequate for such prediction.
>
> Almost all external users of financial information reported by a profit-oriented firm are involved in efforts to predict the earnings of the firm for some future period. Such predictions are most crucial in the case of present and prospective investors. . . . Future earnings are the chief determinant of future dividends and future market prices of shares . . . which, when taken together, are generally considered to provide the primary basis for establishing a subjective value for the shares in the mind of the user. . . .[17]

The Committee stresses predictability in connection with information to be used by equity investors. It also emphasizes that forecast information because of its high

degree of relevance is useful for internal purposes, even though forecasts possess a very low degree of verifiability. In addition, the Committee states that "as this theory (management theory) continues to develop, external reporting will be expanded to encompass more measurements of managerial actions, structure, and perhaps even plans."[18]

The Committee recognizes that financial forecasts are relevant information to investors and management but that relevance must be sacrificed at times in order to meet adequately the standard of verifiability. The Committee reasoned:

> Accountants generally refrain from reporting budgets relating to future periods to external users, on the ground that the information is not sufficiently verifiable, although it might be highly relevant to external user's needs. Failure to observe the standard of verifiability to a minimum degree would place the accountant, in some cases, in the role of forecasters and would reduce the confidence of the users and thereby diminish the usefulness of accounting reports. We believe that a substantial level of verifiability is most important for externally reported accounting information.[19]

Thus, the Committee takes the position that forecast information does not meet the criterion for external reporting on the ground that information of this nature cannot be satisfactorily verified.

Securities and Exchange Commission

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted for the purposes of providing meaningful information to investors on a continuing basis.

Despite these Acts under which S.E.C. operates, the long standing policy of the Commission was that disclosure of forecasts be prohibited. For many years the Commission neither required nor permitted forecasts in reports filed with the Commission. This policy was based primarily on the belief that material deviations between forecasts and actual results take place frequently. Securities Exchange Act Rule 14(a)-9 offers predictions of earnings as an illustration of what may be inherently misleading.[20] The Commission has relied on this concept of "inherently misleading" in support of its forecast prohibition.

However, as mentioned in Chapter II, the Commission has changed its long-standing policy of the forecast prohibition to initiate the implementing of the publication of forecasts. As a first step, in late 1972 the Commission held public hearings for the purpose of gathering information to be used in considering rule-making policies regarding the use of forecasts in reports filed with the Commission.

Based on the information gathered from the public hearings and on the basis of recommendations made by the staff of its Division of Corporate Finance, on February 2, 1973, the Commission released a statement on the "Disclosure of Projections of Future Economic Performance." This new policy is a further step toward a logical extension of corporate disclosure of forecasts in which the Commission

has determined the following:[21]

1. Disclosure of projections in Commission filings should not be required except under the circumstances set forth in Paragraphs 7 and 8, below.

2. Issuers who are reporting companies and who meet certain standards relating to their earnings histories and budgeting experience should be permitted to include projections in filings with the Commission pursuant to the Securities Act and the Exchange Act.

3. Projections disclosed in Commission filings should meet certain standards, for example, the underlying assumptions should be set forth, the projection should be of sales and earnings and expressed as a reasonably definite figure, and the projections should be for a reasonable period of time.

4. Any issuer who files projection information should be required to update the filed projection on a regular basis and whenever the issuer materially changes its projection.

5. Any issuer who has previously filed projection information should be allowed to stop filing such information if it discloses its decision and the reasons therefor.

6. No statement of verification or certification of the projections by any third party should be permitted in any filing with the Commission at this time.

7. Any issuer who discloses projections outside of filings with the Commission, whether through financial media, financial analysts or otherwise, should be required to file such projections with the Commission on a special projection form.

8. Any issuer subject to the reporting requirements of the Exchange Act who discloses a projection, whether in a Commission filing or not, should be required to include in its annual report on Form 10-K for the fiscal year during which the projection was made, a statement of the projection made, the circumstances under which it was disclosed, and a comparison of the projection with actual results.

9. The Commission should adopt rules under the securities law to define the circumstances under which a projection would not be considered to be a misleading statement of a material fact.

10. The Commission should issue a release setting forth certain standards for the preparation and dissemination of projections by management of public companies, financial analysts, and other members of the financial community. The release should highlight the Commission's reservations as to whether anyone who makes a projection with respect to an issuer having a limited history of operations can meet the standards necessary to avoid liability. In addition, the adverse consequences of selective disclosure of material information such as projections should be emphasized.

The Commission has determined not to require issuers to disclose forecasts. Although the Commission proposed that disclosure of projections in Commission documents would be voluntary, the Commission is also considering a requirement that any issuer who discloses forecasts outside of filings with the Commission, whether through financial media, financial analysts or otherwise, should be required to file such projections with the Commission.[22]

The Commission contemplates that issuers who file forecasts with the Commission would be required to update those forecasts on a regular basis, and if there have been material changes in the forecasts. Further, the Commission has determined not to allow any statement of verification by any third party to be disclosed in filings with the Commission at this time. With regard to the liability for inaccurate forecasts, the Commission has adopted a proposed rule that a forecast is not a promise that it will be

achieved nor per se misleading if not achieved. The Commission has proposed that a forecast would not be considered to be a misstatement of a material fact if it were reasonably based on fact and prepared with reasonable care and closely reviewed.

The Commission also noted that action taken in the form of the preceding proposed rules would be in the nature of an experiment and would be carefully monitored by the Commission. Apparently the Commission will develop standards and guidelines to enable all issuers to understand their responsibilities and all investors to have equal access to forecast information.

The Experience of Profit Forecasts in the United Kingdom

The practice of profit forecasts in the United Kingdom which started in 1968 also contributed to the recent interest in the subject of forecasts in this country. Although financial reporting practices in many countries of the world have developed along different lines because of varying social, economic and environmental influences, the basic objective of financial reporting is similar. Therefore, an examination of the British experience in profit forecasts should provide another insight into the subject.

Historical Background of Profit Forecasts

In the last two decades, there have been many take-over bids and mergers in the United Kingdom. In most cases, these merger activities were carried out on a negotiated basis. Generally, both offeror and offeree companies send documents relating to future prospects before mergers, including a profit forecast, to stockholders. However, because there was no set of rules or principles in connection with the preparation of forecasts, certain take-over transactions were often contested and invoked public criticisms.[23]

In July, 1967, following much criticism on certain take-over transactions, the Governor of the Bank of England requested that the City Working Party (a voluntary organization created in 1959 to cope with problems of mergers and take-overs) correct the abuses prevalent in take-over transactions. In March, 1968, the City Working Party produced the City Code on Take-overs and Mergers which included a set of principles and rules to be used as guidelines for conduct of both offeror and offeree in bid situations.

For the guidance of its members, the Council of the Institute of Chartered Accountants in England and Wales, in cooperation with the City Working Party, issued a statement, entitled "Accountants' Reports on Profit Forecasts."[24] The Statement outlined the problems relating to profit forecasts and the limitations of an accountant's capacity to

report thereon. The Statement also provided the main points that the reporting accountant should consider when reviewing and reporting on forecasts. However, the Statement recommended that accountants should not allow their names to be associated with such forecasts in published documents.

Though accountants had no public reporting responsibility for forecasts appearing in take-over documents, they frequently reported to merchant bankers on forecasts in comfort letters. Because of this practice of private reporting, accountants were increasingly pressured to publish their reports on profit forecasts. Both merchant bankers and the investing public demanded that accountants be associated publicly ith profit forecasts.[25] To satisfy an increasing demand placed on the chartered accountants, the Institute requested that Rule 15 of the City Code be revised. In response to the Institute's request, in April, 1969, the City Working Party issued an amended set of principles and rules on take-overs and mergers. Rule 15 of the Code was revised substantially. The rule reads in part:

> When profit forecasts appear in any document addressed to stockholders in connection with an offer, the assumptions including the commercial assumptions, upon which the Directors have based their profit forecasts, must be stated in the document. The accompanying bases and calculations for the forecasts must be examined and reported on by the auditors or consultant accountants. Any merchant banker or other auditors mentioned in the document must also report on the forecast. The accountants' report and, if there is an adviser, his report must be contained in such document and be accompanied by a statement and where relevant, the advisers have

> given and not withdrawn their consent to publication.[26]

In April, 1969, the Council of the Institute of Chartered Accountants in England and Wales issued a revised statement, "Accountants' Reports on Profit Forecasts," with a particular reference to the revised Rule 15 of the City Code. The revised City Code and the revised version of the Institute's statement thus for the first time required an accountant to report publicly on a profit forecast. Chartered accountants are now required to consent to the report on profit forecasts. They must now not only review profit forecasts in take-over situations, but also must report their findings to the investing public.

The Experience of Profit Forecasts

An accepted practice in the United Kingdom is that reporting accountants must satisfy themselves as to whether profit forecasts have been prepared with reasonable assumptions by the directors. Practice Note No. 6 of the Code sets forth the responsibility of the auditors and merchant bankers:

> The forecast and the assumptions on which it is based are the sole responsibility of the directors. However, a duty is placed on the financial advisers to discuss the assumptions with their clients and to satisfy themselves that the forecast has been made with care and consideration. One of the duties placed on the auditors or consultant accountants is to satisfy themselves that the forecasts, so far as the accounting bases and calculations are concerned, have been properly compiled on footing of the assumptions made.[27]

If accountants do not agree with the assumptions on which

the forecasts are based, they are expected to disassociate themselves from profit forecasts.

Thus, the accounting profession in the United Kingdom has accepted certain aspects of responsibility for forecasts. According to the Study reported by D. R. Carmichael, the Director of Technical Research Division of the American Institute of Certified Public Accountants, the English accountants were at first quite reluctant to report publicly on forecasts, even though they had a fair amount of experience in reporting on forecasts. After some years of experience, they seemed more comfortable with the public reporting responsibility and many accountants felt that public reporting on forecasts was not significantly different.[28]

In addition to the accountants' attitudes toward forecasts, the accuracy of forecasts made under the British system is also most encouraging. In a report of the Panel on Take-overs and Mergers concerning a study of 210 forecasts made after May, 1969, 170 were classified as having been achieved within plus or minus 10 percent. Of the 40 which deviated more than 10 percent, 18 forecasts were satisfactorily explained by reasons which had an effect on the results that were genuinely unforeseen.[29]

The accuracy of forecasts and the changing attitudes of chartered accountants have been favorable, and they have contributed to the continuation of the forecasting

practices in the United Kingdom. The success of the British experience in profit forecasts does not, however, mean that their experience can be extrapolated directly into this country. There is a substantial environmental difference between two countries. Nevertheless, the British experience can provide another insight into the proposal for publication of forecasts in this country.

Current Forecast Reporting Practice

As presented earlier, one strong argument in support of the publication of forecasts is that forecasts are currently prepared, disseminated, and used in an unregulated way and that only some corporations participate and only some investors have access to the information. The argument is that required forecasting would thus assure more uniform practices and equalize investor access to this information. Examination of current practice of forecasts therefore can refute or support the argument advanced.

Although the type and quantity of forecast information being reported vary among firms, many studies report that forecasts are currently made available to investors outside the firm. Review of literature indicates that forecasts are currently available generally in the form of (1) forecasts prepared by financial analysts, (2) press release, (3) presidents' letters contained in the financial statements and (4) forecast financial statements.

Financial analysts usually make their own forecasts

for certain companies and then seek to ascertain management's expectations through interviews. Though most companies are reluctant to disclose detailed operating plans, they will usually comment on the forecasts prepared by financial analysts. Morton Backer reported that approximately 40 percent of the companies visited do not publish forecasts, but would comment on whether an analyst's forecasts fell between plus or minus 10 percent of the company's forecasts. Backer also reported that about 33 percent of the companies included in his study disclosed forecasts publicly through special meetings with financial analysts or stockholders' meetings and a press release.[30]

Some companies disseminate forecasts through press releases. The study, sponsored by the Financial Analysts Federation, made an analysis of forecasts which appeared in the <u>Wall Street Journal</u> from October, 1971, to September, 1972.[31] For this purpose a forecast was defined as a projection about some aspect of a company's performance with a minimum time of three months. The study identified 89 forecasts made by 73 corporations during this period. Although there was no uniformity as to the periods of forecasts (i.e., ranging from three months over one year) and the information contained in the published forecasts, the survey of forecasts conducted by this study provides evidence that public forecasting does exist.

Comments on future prospects, which are rarely

quantified, such as managerial evaluation of the level of profitability and sales for the coming year and management's expectations of the economy for the coming year with anticipated effects on the operations of the company, are frequently included in the financial statements or in the president's letters. For example, the Sun Oil Company included the following comments on future expectations in the 1972 published annual reports:

> The need to reorient strategies becomes clear from a systematic examination of the internal and external circumstances of the company. Alternatives were developed through the formal planning process and forecasts based on several different assumptions were presented to the board of directors. . . . At this point, the immediate outlook for Sun is brighter than was the case a year ago, but the outlook from the viewpoint of public policy is less certain.[32]

Forecast financial statements are not yet widely disseminated. However, some companies have started publishing forecast statements. For example, in its release of the preliminary annual report, the Fuqua Industries, Inc., included an estimate of 1972 operations and a forecast of operations for 1973. The income statement was presented in three columns which present the actual results of operations for 1971, unaudited estimates of 1972 results and forecast results for 1973. The balance sheet reports 1971 actual results and 1972 estimates. The report itself contains no statement of assumptions underlying the forecast, but it is accompanied by the chairman's letter which states:

> It should be clearly understood that 1972 figures are unaudited and subject to possible adjustment. However,

in a well managed company, the independent auditors do not create financial data but should only have to verify that company figures are accurate and presented in a manner consistent with prior years. . . . We urge you understand that forecasts of future operations are based on business factors as evaluated by management at the time such forecasts are made. . . . In order not to mislead investors, we believe our 1973 forecasts to be conservative, representing our minimum anticipated from the financial performance as we see economic and competitive factors in December 1972.[33]

At the beginning of 1973, the L. T. V. Corporation also released forecast income statement which included forecast sales, expenses, net income and earnings per share. The statement was accompanied by a letter to stockholders which said:

As is the case in most business enterprise this is not normally our practice. Generally, I tend to regard public forecasts with concern because of the complexities and variables involved in all business projections. It is our view, however, that it is in the best interests of our shareholders to make public the outlook for LTV for the year 1973 due to the company's rather dramatically altered circumstances. . . . Our earnings estimate points toward a sharply improved picture. We feel our shareholders, employees, and the investment community are entitled to this information. . . . These estimates, which represent our internal planning assessments for the year, are a matter of management judgement. I thus wish to stress they could prove to be wrong if the assumptions on which they are based change later in the year. Because it is far from a precise science, public forecasting of sales and earnings is a hazardous business, one which we feel can be justified only by unusual circumstances prevailing at this juncture in the history of LTV. . . . I would like to point out that, having taken this action, we will publish during the course of the year a revised forecast--up or down--should business conditions or circumstances not now anticipated indicate a subjective change. In analyzing this forecast, it should be borne in mind by all shareholders that the near-term earnings outlook of a company is only one of many factors that should be looked at in making prudent investment decisions.[34]

The forecast released by the L. T. V. corporation is presented separately from historical data, and is the one considered most likely to occur in 1973. In addition to the forecast information, the forecast included an explanation of some assumptions on which the forecast was based, such as 10 percent increase in Gross National Product.

The foregoing analysis of the current forecast practice provides some evidence that forecasts of some companies are published in one form or another and are available to the public. The study, sponsored by the Financial Analysts Federation, supports the argument that corporate forecasts are currently rather widespread. After an extensive opinion survey, the study concluded the following:

1. It seems to be the respondents' impression that corporate forecasting is currently rather widespread;
2. Slightly more than 40 percent of the respondents feel that they receive some type of forecasts from more than half of the companies they follow;
3. Most respondents felt that there was a wide gap in the availability of forecast information between professionals and other information. They also felt that management forecast was a significant piece of information and that it played an important role in the decision-making process.[35]

Implications to Financial Reporting

As presented in the preceding section, both the American Institute of Certified Public Accountants and the American Accounting Association have taken the position that forecast information does not meet the criterion for external reporting on the ground that information of this

nature cannot be satisfactorily verified. Their positions have been based on the belief that historical data are based on factual and objective evidence while forecasts are not. Even historical information, in some instances, does involve estimates or some assumptions as to the future. The ultimate collection of cash from the credit sales and the estimation of the useful life of productive assets are some examples. Gordon Shillinglaw, Professor of Accounting at Columbia University, noted:

> These estimates and forecasts are necessary because the accounting period is shorter than the life of the business enterprise, and events that take place in one accounting period have effects that may continue for many accounting periods to come. This means that every accounting statement for a given concern is no more than an informed approximation to the true results of events during the accounting period.[36]

Even granted that forecasts lack objective evidence as compared to historical data, "objectivity" is not the sole criterion for information to be included in financial statements. Relevance is often more important as a standard for information. William H. Beaver contends that "the premise is that accounting data can be evaluated in terms of their utility and that utility can be defined in terms of predictive ability."[37] This point was reaffirmed by the Committee to Prepare _A Statement of Basic Accounting Theory_ of the American Accounting Association:

> Accounting information must be useful to people acting in various capacities both inside and outside of the entity concerned. It must be useful in the formulation of objectives, the making of decisions or the definition and control of resources to accomplish objectives. The

> utility of information lies in its ability to reduce uncertainty about the actual state of affairs of concern to the user.[38]

For information to be useful and relevant, the predictive ability should be the first order criterion. If this is so, forecasts are relevant to investors because this information could reduce some of the uncertainty about the future and provide investors with a useful basis upon which to judge the expected future earnings of the company.

Emphasis upon forecasts does not imply that accounting data are the only useful variable for the prediction of a company's expected earnings. Investors must take into account many other factors such as timing preference and risk factors. These other factors also influence investors in making their decisions. Although a complete model for estimating a firm's share-price cannot be specified, investors would be better informed if forecasts are published and made available to investors.

Also emphasis upon forecasts does not mean that historical information should be abandoned. Past information is also useful in the sense that a meaningful comparison can be made between the past accomplishments and expectations. Information on past activities is provided under the current practice. However, relevant information about future expectations is not available in the current financial statements. Proposed, therefore, is that forecasts should be included as a part of published financial package.

As presented earlier, there are also many practical difficulties in the implementation of the publication of forecasts. These difficulties can be considered the incremental costs of the publication of forecasts. The Committee of External Measurement and Reporting of the American Accounting Association stated that:

> The cost of disclosure may be considered in two parts:
> 1. The incremental cost to the business enterprise of compiling, determining and presenting additional information to disclose.
> 2. The cost to the business enterprise of disclosing information publicly considering such factors as possible loss of competitive advantage, loss to shareholders of having information publicly disclosed, and the legal implications of disclosure.
>
> The incremental direct costs of additional disclosure in most cases may be estimated with reasonable accuracy. The costs outlined in two above, however, would require a degree of subjective judgment to estimate, and in fact, may not be quantifiable. However, they do represent some qualitative constraints that should be considered when weighing the cost versus the benefits. Benefits derived from added disclosure should be considered from the standpoint of the real meaningfulness to the primary users of statements--present and potential investors. Benefits to other users must also be considered. If it is determined that financial statements have a broader purpose--the providing of information to assist in planning and attaining social goals--then the benefits to society of additional public disclosure should also be considered.[39]

The proposal for the publication of forecasts therefore requires weighing the incremental costs versus the benefits of the publication of forecasts which represents a very important consideration in the implementation of the publication of forecasts.

Summary

This chapter defined financial forecasts as"quantified financial information, published for external users, of the future expected or planned events and transactions of the company which are most likely to occur for the coming year."

The relationship between the forecast information and a share-price model was then examined. Since the present value of a stock is directly affected by the future expected earnings of a company, determining future expected earnings is critical in making investment decisions. Because the future is uncertain, investors attempt to reduce the degree of uncertainty with the aid of financial information. Based on this proposition, publication of forecasts has been advanced as an extension of financial reporting.

Many conflicting viewpoints both for and against the publication of forecasts were identified. Major arguments in opposition to the publication of forecasts are: (1) the capability of investors to understand inherent limitations of forecasts, (2) the creation of a competitive disadvantage, (3) the potential for legal liability, (4) management conservative attitudes, (5) the potential dangers of manipulation, (6) the incremental costs, and (7) a general loss of investors' confidence in financial reporting.

Major arguments in support of the publication of forecasts are: (1) the relevance of forecast information

for investment decisions, (2) inadequacy of historical information, (3) current prejudicial practice, (4) evaluation of management performance, (5) meaningfulness of forecasts prepared by management (as compared to those prepared by financial analysts), and (6) efficient resource allocation.

To gain a further insight into the subject, the current practice of forecasts was examined. Since the financial reporting practice in this country has been influenced mainly by the American Institute of Certified Public Accountants, the American Accounting Association, and Securities and Exchange Commission, the positions taken by these organizations were examined. Their traditional positions were that the American Institute of Certified Public Accountants, the American Accounting Association as well as the Securities and Exchange Commission have been reluctant to have forecasts disseminated to the public. However, the Securities and Exchange Commission has changed its long-standing policy of forecast prohibition and has taken the initiative to implement the publication of forecasts. The Commission released a statement on the "Disclosure of Projections of Future Economic Performance" on February 2, 1974. This new policy is a further step toward an extension of corporate disclosure of forecasts.

Because the practice of profit forecasts in the United Kingdom also contributed to the recent interest in

the subject of forecasts in this country, the British system of forecasts was examined. The experience with forecasts in the United Kingdom, such as the changing attitudes of accountants and the accuracy of the profit forecasts made, has been most encouraging in England.

Finally, the current practice of forecasts in this country was examined. At present, forecasts are generally published in the form of (1) forecasts prepared by financial analysts, (2) press releases, (3) comments contained in the financial statements and (4) forecast financial statement. The analysis of the current forecasting practices provides some evidence that, although the type and quantity of forecasts published are not uniform, forecasts are currently available in one form or another.

Finally the implications of current controversy and practice to financial reporting were drawn. Asserted was that relevance is the first order criterion for information to be useful and therefore forecast information should be published as a part of financial information. Noted too was that the incremental costs of the publication of forecasts should also be considered.

FOOTNOTES

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CHAPTER IV

RESEARCH METHODOLOGY

Introduction

One of the objectives of this research was to obtain empirical evidence bearing on the subject of financial forecasts. This chapter presents the research methodology employed in the empirical investigation. Included are the questionnaire design and testing, sampling procedure, pattern of survey responses, and methods of data analyses.

Questionnaire Design and Testing

Design of a Questionnaire

Because a questionnaire is a channel through which empirical data can be obtained, one critical step in this investigation was the design of a suitable questionnaire. Preparation of a suitable questionnaire was a difficult task. The only possible way suitable questions and statements could be prepared was through study of relevant literature. The writer extracted possible statements and questions which would best describe the current controversy surrounding the subject. Since the length of the questionnaire was considered to have an important effect on the

ultimate questionnaire response, an attempt was made to minimize the number of questions and statements as much as possible, while covering the subject adequately. The decision to include some statements and questions, while excluding others, had to be made subjectively because there was no set of criteria that indicates whether a given question or statement is suitable.

The Content of the Questionnaire

The questions and statements included in the questionnaire are not exhaustive, but do, however, represent the subject.

The questionnaire (see Appendix A) consists of five parts: (1) general, (2) advantages and disadvantages, (3) financial reporting, (4) attestation and (5) legal implications. Part I contains seven questions such as the adequacy of current financial reporting practice and the feasibility of publication of forecasts. Part II includes twelve statements which concern arguments both for and against the publication of forecasts. Part II was designed with the intention of extracting the most important factors describing the subject. Both Part I and Part II were asked on a five point scale: strongly agree, agree, undecided, disagree, and strongly disagree, so that each question or statement could be quantified for later statistical analyses. An "undecided" column was provided for those who were indifferent to the subject or who had no definite opinions

on the subject.

Parts III, IV and V asked what should be done if forecasts were published. Differences in the nature of possible answers of each question precluded uniform tabulation of data. To assign a value to each answer was not possible. Therefore, no attempt was made to quantify the answers to questions included in Parts III, IV and V. Part III asked nine questions pertaining to financial reporting. Part IV inquired as to the problems of attestation to the forecasts, and Part V included some important legal problems.

Questionnaire Testing

A number of revisions were made after the first draft was prepared. Nevertheless, a questionnaire can never be perfect. It could fail to ask relevant questions; it may be misinterpreted; it may be too detailed, resulting in nonresponse.

In order to minimize these problems described above, a pretest of the questionnaire was considered necessary. Prior to a pilot study, interviews were arranged in Oklahoma City with two partners in public accounting firms, a controller of an industrial corporation and a practicing financial analyst. Each interviewee was asked if he had found any problem in answering the questionnaire. In addition, the following questions were asked:

1. Was there any question for which more than one answer

could be given when only one answer should apply?

2. Were any irrelevant questions and statements asked?

3. Was there any information omitted?

4. Were any ambiguous questions and unfamiliar statements asked?

5. Did the questionnaire adequately cover the subject?

After further revisions based on comments by these interviewees and consultation with the reading committee, the questionnaire was determined ready for field testing.

The revised questionnaire was sent out as a pilot study. A further effort was made in the pilot study to minimize any possible misinterpretations and to determine if further revisions were necessary. A total of twenty-one questionnaires was sent to Financial Analysts, Certified Public Accountants and controllers of the Fortune 500 largest U.S. industrial corporations. Each participant was told of the need for a pilot study, stressing that the design of the questionnaire was critical to the success of the study. Each participant was also asked to give various comments and/or suggestions with respect to the submitted questionnaire on the following points: (1) clarity of the questionnaire, (2) time required to answer the questionnaire, (3) degree of understandability, (4) format, (5) content of the questionnaire.

Approximately two weeks later, eight questionnaires were returned. Since the test of collectibility was also

one of the important objectives of the pilot study, a second request was made to the same group. Six questionnaires were returned from the second mailing. Thus total responses from the pilot study amounted to a 67 percent or a total of fourteen responses. Most of the respondents just checked or circled as instructed in the questionnaire. However, one corporate executive and one partner of an accounting firm made various comments and suggestions. The questionnaire was then revised and printed in final form. A copy of the cover letter and the questionnaire are included in Appendix A.

Sampling Procedure

Sampling procedure consists of three steps: (1) definition of the population, (2) determination of the sample size and (3) sample design.

Definition of the Population

The population sampled consists of those interested in publication of forecasts. John C. Burton has said:

> Because of its importance in appraising success and making decisions, corporate financial reporting is an important interest of many professional groups in our economic society. Managers charged with the responsibility of reporting the results of their firm's economic activities clearly have a primary concern. So do public accountants who must review these financial reports and attest to their fairness of presentation. Finally those who use this information in decision-making of various sorts are also vitally interested in its form and content. Among such groups the financial analysts who must make investment decisions and guide the decisions of others in the economy have an obvious interest.[1] (emphasis added)

Apparently those interested in the publication of forecasts are three major groups as John C. Burton specified. No doubt corporate management is intensively concerned with the proposal for publication of forecasts. An equally interested group would be investors who would use forecast information for their informed decisions. Between these two groups may be public accountants who would review and attest to the fairness of management expectations. Therefore, the population in this research is defined as consisting of three groups: corporate management, financial analysts and public accountants.

Management of Major Corporations

The first group of the population is the management of major corporations. They are the preparers of the forecasts. Many persons of varying positions and different levels in the corporation may prepare the forecasts, but the controller of the corporation seems to have final responsibility for the forecasts. The controllers of major corporations, specifically the Fortune 500 largest U.S. industrial corporations, were defined as the first group of the population.

This identification of the first group introduces some systematic biases which are difficult to assess. However, the findings of the study should not suffer. These corporations represent not only a majority of the market value of the publicly-owned corporations but also comprise

a substantial portion of the industrial sector of our economy. The list of the Fortune 500 largest U.S. industrial corporations excludes privately owned corporations that do not publish financial statements, but the Fortune 500 largest U.S. industrial corporations account for about 65 percent of the sales, and three quarters of the profits and employment of all U.S. industrial corporations.[2]

This selection criterion was also based on the assumption that larger corporations play an important role in the development of corporate reporting practice. Maurice Moonitz has said:

> We should design financial reporting standards and auditing standards for all company that go to the public. Their financial reports must be reliable and comprehensive if capital is to flow freely on the basis of adequate knowledge by investors. By contrast, the public at large does not have the same interest in the financial reports of these companies not seeking outside financing. We could concentrate to the listed companies, and let them influence the rest.[3]

Certified Public Accountants

The second group of the population is Certified Public Accountants. The estimated number of CPAs in this country is about 125,000.[4] Because some are not active in practice, CPAs were defined as practicing CPAs in the United States.

The practicing CPAs were assumed to be well qualified in their profession as they have passed all the required examinations of the American Institute of Certified Public Accountants. The identification of this group

was based on the assumption that if forecasts were published, CPAs would review and attest to the fairness of management expectations and thus increase the credibility of the published forecasts.

<u>Chartered Financial Analysts</u>

The third group is defined as Chartered Financial Analysts. CFAs are not the only group for whom information is published, but they are among the most intensive users of corporate financial information. Professor R. K. Mautz justified the selection of CFAs as a representative of investors in the following way:

> Financial analysts were selected as the group to represent the views of all those who read and rely on reported corporate financial data. They seem to be satisfactory representative of this point of view because, as a group, they include a diversity of positions and interests and because they include in their ranks of the most sophisticated of all users of published financial statements.[5]

To the extent an individual investor desires to make informed decisions, he needs the same information as CFAs. Therefore, if the needs of CFAs are met, investors should be supplied with at least as much information as they can use effectively.

Determining the Sample Size

One consideration given in the determining of the sample size was the review of the previous studies as a frame of reference. Although Asebrook and Carmichael used a sample size of 2,400,[6] Backer and McFarland selected 72

financial analysts and 71 commercial bankers, and interviewed executives of 70 large industrial corporations for their empirical research. They justified a sample of this size, for instance, with respect to the selection of financial analysts by stating that "it seems reasonable to expect that the interviewees are representative of skilled professional users of financial reports in investment decisions."[7] J. Fred Skousen, Professor of Accounting, Brigham Young University, sent 105 questionnaires to corporate management, professional analysts and Certified Public Accountants. He received sixty-eight usable responses from this mailing. With this result, Skousen stated that

> . . . because of the limited number of responses, one cannot draw universal conclusions from this study, but the findings provide reliable indications of the realities surrounding the question of budgetary disclosure.[8]

Another consideration given to the determining of the sample size was the importance of a balance between the desired reliability and cost. If too few were selected, the sample may not reveal the characteristics of the population, and the result of the study would not render accurate and reliable results. However, the sample size need not be too large to obtain reliable results. Properly selected, a sample can yield a sound basis for understanding the characteristics of the population. The sample chosen will not differ very much from the characteristics of the population if each element be chosen carefully.

Of course statistical theory must be consulted in sampling, but equally important is the fact that judgment is indispensable. William E. Deming states that "in modern sampling, judgment and all possible knowledge of the subject matter under study are put to the best possible use . . . for instance, in defining the kind and size of sampling units."[9] A compromise had to be made between the desired accuracy of the results and the resources available in terms of cost and time.

In view of these considerations, a sample size of more than 200 was considered to be reasonable. After discussion with the reading committee, the decision was that a sample of 210 should be used, seventy for each group of the population.

Sampling Design

CFAs and corporate management were selected by using simple random sampling. Depending on the industry to which the company belongs, the opinion on the subject could be expected to vary. Hence, special care was exercised to obtain as a wide range of views and attitudes toward the subject. With the use of random number table, seventy corporations were drawn from Fortune 500 largest U.S. industrial corporations. Questionnaires were addressed to the controller of each corporation. In a similar fashion, seventy Chartered Financial Analysts were selected from the <u>1973 Membership Directory of the Institute of Chartered</u>

Financial Analysts. Special considerations given to the selection of CFAs were (1) he must be a chartered financial analyst (some members listed in the Directory are not chartered financial analysts) and (2) he must be engaged in counseling equity investors.

For a selection of CPAs, a combination of simple and stratified random sampling was employed. Although this group was confined to the practicing accountants, use of only a simple random sampling did not seem appropriate. One reason was that there are so-called "big-eight" accounting firms and other national accounting firms which have their offices in many parts of the country. This group was thus stratified into two strata, that is, the fourteen national accounting firms and others. As presented in Table 1, these fourteen accounting firms dominate the profession. The assumption is that these fourteen accounting firms' views lead the profession and that the position taken by these firms influences the employees of the firm. Patterned responses, therefore, could be expected on the questionnaire sent to different offices of the same firm. The main office of these fourteen national accounting firms was considered as a sampling unit. A questionnaire was addressed to the partner-in-charge-of-audits in their main offices. The remaining fifty-six accounting firms and CPAs were selected randomly from the Accounting Firms and Practitioners: 1971, which lists all accounting firms and

TABLE 1

NUMBER OF COMPANIES WHOSE FINANCIAL STATEMENTS WERE AUDITED BY THE DIFFERENT FIRMS AND PERCENTAGE AUDITED BY EACH FIRM

Auditors	1965		1969		1970		1971	
	No. of Cos.	% of Total	No. of Cos.	% of Total	No. of Cos.	% of Total	No. of Cos.	% of Total
AA&Co.	85	8.8%	131	12.2%	157	13.9%	159	12.8%
AY&Co.	46	4.8	61	5.7	58	5.1	72	5.8
E&E	96	9.9	123	11.5	123	10.9	138	11.1
H&S	74	7.6	80	7.4	86	7.6	92	7.4
LRB&M	62	6.4	75	7.0	85	7.5	94	7.5
PMM	112	11.6	124	11.6	126	11.1	139	11.2
PW&Co.	101	10.5	102	9.5	111	9.8	114	9.2
TR	44	4.6	58	5.4	65	5.8	86	6.9
Big 8	620	64.2%	754	70.3%	811	71.7%	895	71.9%
AG&Co.	5	.5%	14	1.3%	14	1.2%	23	1.8%
J.K. Lasser	11	1.1	18	1.7	17	1.5	19	1.5
M. Laf.&Co.	10	1.0	12	1.1	16	1.4	22	1.8
LKH&H	1	.1	17	1.6	21	1.9	21	1.7
SDL	24	2.5	27	2.5	28	2.5	29	2.3
S&S	14	1.5	16	1.5	15	1.3	13	1.0
Other	280	29.1	214	20.0	209	18.5	222	18.0
	345	35.8%	318	29.7%	320	28.3%	349	28.1%
Total	965	100.0%	1072	100.0%	1131	100.0%	1244	100.0%

NOTE: 1971 includes companies with trading suspended whereas 1965-1970 excludes companies with trading suspended.

TABLE 1 (Continued)

SOURCE OF DATA: 1965-1970, inclusive--Companies were listed from Barrons year end stock market quotation summary for the American Stock Exchange.

This list excluded companies for which trading was suspended at year-end but the securities still listed. We have not been able to determine those companies with trading suspended in order to make the totals for these years comparable to 1971.

1971--Companies were listed from Commerce Clearing House American Stock Exchange Guide. This list includes all companies listed, including those with trading suspended at year-end.

Auditors and company headquarters were determined from the annual reports of the individual companies to the extent such reports were available; where they were not available, the information was taken from Moody's Manual.

individual practitioners in this country.

Pattern of Survey Responses

On August 7, 1973, a questionnaire, an introductory letter and a return envelope were mailed to 210 selected Chartered Financial Analysts, Certified Public Accountants and controllers of the Fortune 500 U.S. Largest Industrial Corporations. An introductory letter explained the purpose of the study, and assured the potential respondents that the information would be kept in the strictest confidence, using only aggregate totals for the dissertation. The first mailing resulted in eighty-four responses.

Since the responses from the first mailing were considered insufficient to render reliable results of the study, on September 24, 1973, a second request was sent. Another letter was included in the questionnaire, stressing that each person had been singled out to participate in the study and that an individual response would make a meaningful contribution to the success of this research project. In order to facilitate the completion of the project, October 31, 1973, was established as a cut-off date. As of this date, forty-nine questionnaires had been returned from the second mailing.

With the initial mailing and the second request, a total of 123 usable questionnaires had been received, giving an overall response rate of 59 percent. Of the

total 133 returned questionnaires, ten respondents refused to participate in the study. A variety of reasons were given for refusals. One CPA, for example, said: "Sorry, our company is too small to be of any service to you." One controller included this note: "This questionnaire is too detailed. I would be pleased to respond to a few questions." Another controller noted: "We are acknowledging your letter of August 7, 1973, and regret very much that we cannot comply with your request. The number of similar requests has reached such proportions that it has been necessary for us to establish a policy of nonparticipation."

Despite some clear refusals, the other participants were encouraging in this research project. Although this research project was conducted by an individual and no other introductory letters from the professional organization were included in the questionnaire, the response rate was surprisingly high. One possible reason for such a high response rate could be attributable to the fact that the population defined in this study has an intensive interest in the subject.

Table 2 summarizes the survey pattern, and presents a detailed breakdown of the responses by groups. As can be seen from the table, CPAs were, in general, the most cooperative. Whereas, 70 percent of the CPAs responded, 63 percent of the management and only 43 percent of CFAs returned the usable questionnaires.

TABLE 2

PROFILE OF QUESTIONNAIRE RESPONSES

Group	No. of Questionnaire Mailed (1)	Total Responses Received (2)	Usable Responses (3)	Responses Rate (4)=(3)/(1)	Unusable Responses
Management	70	49	44	63%	5
CPAs	70	54	49	70%	5
CFAs	70	30	30	43%	0
Total	210	133	123	59%	10

No attempt was made to tabulate the respondents by cities or states. The respondents were, however, tabulated in terms of the number of years of experience in the respondent's fields. Table 3 presents the pattern of respondents by years of experience in that 15 percent of the respondents had five to ten years of experience in their fields, and 81 percent, with over 10 years of experience. Thus, 96 percent of the respondents had at least five years of experience. This result assured that the respondents had sufficient experience in their fields and that they were aware of the problems associated with forecasts.

The number of usable responses, based on the assurance that the respondents had sufficient experience in their fields and knowledge of the subject, appeared sufficient for analyzing empirical data to draw current status of publication of forecasts.

Methods of Data Analyses

The approach employed in this research was largely deductive in nature. Various views on the subject were reviewed and evaluated from the review of literature. These differing views were then empirically investigated to judge which position was the most acceptable and practical. At this stage the only feasible way to have some knowledge of the current status of the subject would appear to be the opinion survey of the interested groups in the

TABLE 3

PATTERN OF RESPONSES BY YEARS OF EXPERIENCE

Years & Group	0-5 Years No. (%)	5-10 Years No. (%)	Over 10 Years No. (%)	Total No. (%)
Management	3 (7%)	6 (14%)	35 (79%)	44 (100%)
CPAs	- -	7 (16%)	42 (84%)	49 (100%)
CFAs	1 (3%)	6 (10%)	23 (87%)	30 (100%)
Total	4 (4%)	19 (15%)	100 (81%)	123 (100%)

publication of forecasts.

The first step in the analysis of data was a general consideration with respect to the subject and the general attitudes of the interested groups. Hence, an attempt was made to determine whether there was any consensus among the groups, and if not, the extent of differences in opinion. Multivariate Analysis of Variance was utilized to test the difference among the groups sampled. Under this technique, the observations are divided into groups, with all the observations in any one group being similar in some particular respect. Multivariate Analysis of Variance formulates the null hypothesis in terms of mean vectors. Because there were more than two variables to be tested in the current investigation, Multivariate Analysis of Variance was considered well fitted to the test of the consensus among three groups.

To gather evidence to support the hypothesis that the proposal for publication of forecasts is desirable, the null hypothesis was established as follows:

> There is no significant differences of opinion among the three groups sampled with respect to the proposal for publication of forecasts.

A rejection of the null hypothesis would indicate that the three groups agree that publication of forecasts would be desirable. An acceptance of the null hypothesis would indicate that there is no consensus among the three groups sampled.

The second step in the analysis of empirical data was Principal Components Analysis. Principal Components Analysis is a mathematical technique which transforms the observed variables into uncorrelated linear combinations having maximum variance. This technique determines for a set of p variables a set of m (where $m < p$) factors which account for most of the variance of the original variables and which are uncorrelated. It provides the means whereby the observed relationships presented in a correlation matrix of original variables can be expressed in a similar dimension with little loss of information from the original data. Because this technique produces fewer factors than original variables which maintain essentially the same information as the original variables, it was employed to extract the more important factors from the various arguments advanced with respect to the publication of forecasts. As presented in Chapter III, a number of conflicting viewpoints have been advanced. Twelve important arguments both for and against publication of forecasts were identified and quantified using a five point scale. These twelve arguments were then reduced to a few more important factors so that the various arguments could be ordered in terms of their importance and that further attention could be given to them.

The final step in the analysis of empirical data was tabulating and interpreting the answers to the questions

included in Parts III, IV and V of the questionnaire. Uniformly classifying the answers to the questions included in these parts was, however, difficult. Also, to assign a value to each answer was meaningless because of the varying nature of the questions asked. Consequently, the use of statistical technique was not appropriate. The answers to these questions were tabulated so that the discernible patterns of the opinions could be detected. The relevant literature was also combined with these tabulated answers so that some conclusions could be drawn.

Summary

A questionnaire was prepared to obtain empirical evidence bearing on the subject. Because the design of the questionnaire was critical to the success of the study, special care was exercised for the questionnaire design and testing. A number of revisions had been made after the first draft was prepared. In order to improve the questionnaire, interviews were arranged in Oklahoma City with two partners in the public accounting firms, one controller of an industrial corporation and one practicing financial analyst. After the questionnaire was further revised, field testing was conducted by mailing twenty-one questionnaires to seven financial analysts, seven Certified Public Accountants, and seven controllers of the member of the Fortune 500 Largest U.S. Industrial Corporations.

Because of the impossibility of making a complete

census with respect to the opinions of those interested in the publication of forecasts, the questionnaire was sent to the selected sample of the population. For this purpose, the population was defined as consisting of three groups: management, Certified Public Accountants, and Chartered Financial Analysts. Seventy for each group was selected as a sample of each group. Two considerations given to the determination of the sample size were: (1) the review of the previous studies as a frame of reference and (2) the importance of a balance between the desired degree of reliability and the resources available in terms of cost and time. A total of 210 questionnaires was thus sent to these three groups.

From a total 210 questionnaires sent out, 123 usable replies were received, giving an overall response rate of 59 percent. Ninety-six percent of the respondents who returned questionnaires had at least five years of experience in their fields. This result assured that the respondents had sufficient experience in their fields and that they were aware of the problems associated with forecasts. The number of usable responses, based upon the assurance that the respondents had sufficient experience in their fields and knowledge of the subject, appeared sufficient for analyzing empirical data for drawing meaningful conclusions about the current status of publication of forecasts.

The methods of data analyses consisted of three steps: (1) a test of the consensus among the three groups sampled by using Multivariate Analysis of Variance; (2) Principal Components Analysis to reduce the twelve arguments both for and against publication of forecasts into more important factors; and (3) tabulation of the answers to the questions with simultaneous interpretation in consultation with the relevant literature.

FOOTNOTES

[1]John C. Burton, Corporate Financial Reporting: Conflict and Challenge (New York: AICPA, 1969), p. 1.

[2]The Fortune Directory, The 500 Largest U.S. Industrial Corporations, Fortune (May, 1973), pp. 220-221.

[3]Alfred Rappaport and L. Revsine, Corporate Financial Reporting: The Issues, The Objectives and Some New Proposal (Chicago: Commerce Clearing House, 1972), p. 129.

[4]American Institute of Certified Public Accountants, Accounting Firms and Practitioners: 1971.

[5]R. K. Mautz, Financial Reporting by Diversified Companies (New York: Financial Executive Research Foundation, 1968), p. 146.

[6]Richard J. Asebrook and D. R. Carmichael, Reporting on Forecasts: A Survey of Attitudes, Journal of Accountancy (August, 1973), pp. 28-48.

[7]Morton Backer and Walter B. McFarland, External Reporting for Segments of A Business (New York: National Association of Accountants, 1968), p. 3.

[8]K. Fred Skousen, et al., "Corporate Disclosure of Budgetary Data," Journal of Accountancy (May, 1972), p. 50.

[9]William E. Deming, Some Theory of Sampling (New York: John Wiley & Sons, Inc., 1950), p. 14.

CHAPTER V

FINDINGS OF EMPIRICAL INVESTIGATION I

Introduction

As presented in Chapter I, one of the primary objectives of the present study was to provide empirical evidence bearing on the subject of forecasts. This chapter presents statistical analyses of empirical findings. It presents tests of consensus among the three groups sampled and the results of Principal Components Analysis. Also analyzed are the results of the responses concerning the general aspects of the publication of forecasts. Finally, the results of the study reported by Asebrook and Carmichael on "Reporting on Forecasts"[1] are compared with the present findings.

Statistical Analyses of Empirical Data

The subject of forecasts is not susceptible to a meaningful precise statement. As presented in Chapter III, various conflicting viewpoints exist at present as to the publication of forecasts.

From the theoretical viewpoints, the publication of forecasts is desirable. However, theory generally consists of conclusions developed from a set of assumptions which

may or may not be applicable in practice. The subject of forecast must, therefore, be tested within the environment in which forecasts will be used. Also necessary is the assessing of the relative importance of each argument so that the various arguments can be ordered in terms of their importance.

Tests of Consensus among the Management, CPAs, and CFAs

Hypothesis To Be Tested

Ideally, the views from the three groups should be similar to one another. However, corporate management, independent public accountants and financial analysts could have different views. Thus, the test was specifically directed toward the professional "similarity-difference" hypothesis, that is, to determine whether the empirical data warrant the rejection of the null hypothesis that the means of the three groups sampled are all equal. The null hypothesis established was:

> There is no significant difference of opinion among the three groups sampled in the present study with respect to the proposal for publication of forecasts.

Test of Consensus on General Consideration

The first hypothesis tested was whether the opinions of the three groups are significantly different from one another with respect to the general consideration of the subject.

Dependent variables chosen for analyses are defined in Table 4. Each variable was scored ranging from one to five for the purpose of data analyses (i.e., strongly agree = 5, undecided = 3, strongly disagree = 1). The means of the three groups were obtained as given in Table 5. Because the number of groups is three, an exact F-test was possible.[2]

TABLE 4

DEFINITION OF NINE VARIABLES

Variable No.	Variable that Defines the Item
1	Primary objective of financial reporting
2	Usefulness of current financial reporting practice for investment decisions
3	The relative importance of historical data over forecasts for investment decisions
4	Degree of reliance by investors on historical data
5	Relevance of forecasts information
6	Extent of use in currently available forecasts
7	Reliability of forecasts
8	Feasibility of auditing forecasts
9	Legal aspects of forecasts

TABLE 5

MEANS AND STANDARD DEVIATIONS BY GROUP AND VARIABLE

Factor A			Variable 1	2	3	4	5	6	7	8	9
1	Mgt	M	3.795	3.909	3.273	4.114	2.477	3.250	2.136	1.977	1.909
		SD	0.930	0.520	1.086	0.443	1.045	1.102	1.047	0.927	0.830
2	CPAs	M	3.694	4.020	2.163	3.939	3.367	3.469	2.551	2.041	2.367
		SD	1.357	0.661	1.067	0.852	1.093	0.981	1.119	0.912	0.906
3	CFAs	M	4.200	3.767	3.567	4.067	2.967	3.633	2.667	2.600	2.800
		SD	1.031	1.104	1.073	0.828	0.964	0.964	0.959	0.855	0.805

Since the observed value (F = 2.609; d.f. = 18/224; P less than 0.001) exceeds the tabled value (F = 1.950) at 0.05 level of significance, the null hypothesis for the multivariate test was rejected. The rejection of the null hypothesis indicates that there is no consensus among the three groups sampled on an overall basis. The analysis continued after the overall Multivariate Analysis of Variance test. Location of a significant effect was also important to investigate both the nature and sources of the differences in terms of the variable which contributed to the rejection of the hypothesis. Univariate F-tests are presented in Table 6. Variables 1, 2, 3, 4, and 6 did not show any significance while variables 5, 7, 8, and 9 rejected the null hypothesis.

The results of the test were interesting in that, although there was lack of consensus among the three groups on an overall consideration, the three groups sampled in the current investigation agreed that:

1. The primary objective of financial reporting is to provide sufficient and relevant information for making investment decisions.
2. Current practice of financial reporting based on historical cost is useful for making investment decisions.
3. Investors will continue to rely very much on financial statements based on historical cost.
4. Investors make extensive use of the currently available financial forecasts.

TABLE 6

THE RESULTS OF UNIVARIATE F TESTS FOR NINE VARIABLES ON GENERAL ASPECTS OF FORECASTS

Variable	F(2,120)	Mean SQ	P Less Than
1	1.918	2.499	0.151
2	1.063	0.602	0.349
3	1.332	1.541	0.268
4	0.718	0.378	0.490
5	8.395	9.188	0.001
6	1.312	1.371	0.273
7	2.773	3.096	0.066
8	4.875	3.985	0.009
9	9.863	7.218	0.001

Test of Consensus on Advantages and Disadvantages

The second hypothesis tested was whether there was any consensus among the three groups with respect to the advantages and disadvantages of the publication of forecasts. Twelve dependent variables were defined in Table 7. The variables which represent advantages for the publication of forecasts were quantified on a five point scale as measured in the preceding section. However, variables which represent disadvantages of the publication of forecasts were measured in the reverse order (i.e., strongly agree = 1, strongly disagree = 5).

Multivariate Analysis of Variance was then performed to determine whether any significant differences

TABLE 7

DEFINITION OF TWELVE VARIABLES ON ADVANTAGES AND DISADVANTAGES

Variables	Variable which Define the Item
1	The usefulness and relevance of forecasts for investment decisions
2	Undue reliance by investors on forecasts
3	Inadequacy of historical data for prediction purposes
4	Competitive disadvantage
5	Prejudicial practice
6	Potential for legal liability
7	Evaluation of management performance
8	Management's conservative attitudes
9	Overestimation and deliberate manipulation
10	Disclosure of attendant assumptions used in the forecasts
11	Costs associated with forecasts
12	Loss of confidence in financial reporting

existed among the mean vector for the three groups. The result of the test indicated that lack of consensus is even more significant as compared to the test of consensus on general consideration. The observed value (F = 5.120; d.f. = 24/218; P less than 0.001) exceeds the tabled value (F = 1.760) at the 0.05 level of significance, hence the null hypothesis for the multivariate test was rejected. To determine which dependent variable contributed to the

rejection of the null hypothesis, univariate F-tests were conducted. The result of the univariate analyses of variance along with the F-ratios is summarized in Table 8. As can be seen from Table 8, the disagreement among the groups was presented in eleven of twelve variables. The three groups agreed only that investors would place undue reliance on forecasts despite the inherent limitations of forecasts.

TABLE 8

UNIVARIATE F TESTS BY VARIABLE

Variable	F(2,120)	Mean SQ	P Less Than
1	2.758	2.995	0.067
2	1.415	1.304	0.247
3	1.726	1.357	0.182
4	19.106	13.908	0.001
5	8.948	9.608	0.001
6	19.117	16.290	0.001
7	10.563	10.349	0.001
8	6.805	3.999	0.002
9	4.345	4.231	0.015
10	4.351	3.607	0.015
11	7.542	7.942	0.001
12	5.043	4.149	0.008

Principal Components Analysis

Following the tests of consensus among the three groups, principal components analysis was conducted to extract more important factors from the various conflicting viewpoints.

Twelve variables on advantages and disadvantages of the publication of forecasts were considered the complex from which the important factors could be extracted. The number of factors considered necessary to account for the intercorrelation matrix was determined by obtaining a principal component solution. After factorization, the components with eigen values greater than 1.0 were rotated by varimax rotation.

The rotated factor loadings are given in Table 9. As noted from Table 9, the four largest factors in the data are identified, and these account for about 59 percent of the total variance. These four factors are therefore considered adequate to describe the dimension of the original data. These four factors were tentatively labeled on the basis of the variables which loaded significantly on them and by their common characteristics. For interpretation purposes, an item was considered to be "a marker variable" for a factor if a factor loading was equal to or in excess of 0.50.

Of the four rotated factors, Factor I, which is the most salient and significant, was labeled "legal liability."

TABLE 9

ROTATED FACTOR MATRIX OF TWELVE VARIABLES

Variable	Factor			
	1	2	3	4
1	-0.00786	-0.01868	0.17331	0.79481
2	0.52544	0.54494	0.12636	0.02559
3	0.13614	0.12616	0.87542	0.12798
4	0.37401	0.29922	-0.46575	0.40048
5	-0.01191	0.57344	0.06152	0.37496
6	0.69777	0.05347	-0.21947	0.06529
7	0.15934	0.68410	0.06703	0.15863
8	0.01719	0.76817	-0.08990	-0.09140
9	0.73356	-0.03174	0.13264	0.06300
10	0.19926	0.18036	-0.10423	0.65956
11	0.63127	0.36176	0.16782	0.26203
12	0.77354	0.08873	0.01801	0.03195

Factor I accounted for the most variance in the original items. Although no cause-effect relationship can be ascertained from the correlation matrix, it is clear that other factor loadings on the Factor I also point directly toward the legal liability, such as undue reliance by investors on forecasts (0.52), the dangers of manipulation (0.73) and a general loss of investors' confidence in financial reporting (0.70). A low mean score of the respondents on the legal liability also supports Factor I. As noted from

Table 10, a mean score for management on the legal liability was the lowest among the three groups, and that of CPAs was the second lowest. The low mean scores of the management and CPAs thus suggest that both corporate management and CPAs feel that legal liability would be increased if forecasts were required to be published.

The second factor may be called "management reluctance." This factor is identified by such items as "elimination of prejudicial practice (0.57)," "undue reliance by investors (0.54)," "evaluation of management performance (0.68)" and "management conservative attitudes (0.68)."

Factor III may be termed "inadequacy of historical data." This factor has only one significant item which is inadequacy of historical data for prediction purposes.

Factor IV may be called "relevance of forecasts." This factor shows high factor loadings on "relevance of forecast for investment decisions" and "attendant disclosure of the assumptions."

The preceding four factors provide a structure explaining the relationship between the respondents' attitudes and the twelve variables concerning both advantages and disadvantages of publication of forecasts. These four factors thus appear to be of direct significance to the controversy surrounding the subject of forecasts. The results of the components analysis provide the following implications:

TABLE 10

MEANS AND STANDARD DEVIATIONS BY GROUP AND VARIABLE

Group			Variable											
			1	2	3	4	5	6	7	8	9	10	11	12
Mgt	44	M	3.273	1.886	2.455	2.500	2.682	1.750	2.818	1.932	2.659	3.455	2.250	1.955
	OBS	SD	1.020	0.920	0.875	0.952	1.137	0.781	1.126	0.625	0.963	0.975	1.081	0.714
CPA	49	M	3.673	2.184	2.265	3.367	3.592	1.857	3.735	2.510	2.653	3.837	2.796	2.388
	OBS	SD	1.088	0.950	0.884	0.859	0.956	0.935	0.861	0.893	1.052	0.898	1.040	1.017
CFA	30	M	3.800	2.200	2.067	3.633	3.133	3.000	3.533	2.133	3.267	4.067	3.167	2.600
	OBS	SD	0.997	1.031	0.907	0.669	1.008	1.083	0.973	0.730	0.907	0.828	0.913	0.968

1. The legal liability is an extremely important problem in the implementation of the publication of forecasts.
2. The current practice of financial reporting based on historical cost is inadequate for making investment decisions.
3. Corporate management is reluctant toward the publication of forecasts.
4. One of the most important arguments for the publication of forecasts is that forecasts are relevant information for making investment decisions.

Evaluation of the Responses of the General Aspects of Forecasts

The tests of consensus performed in the preceding section simply indicate whether or not the three groups sampled in the current investigation agreed. However, the results of the tests did not indicate the extent of agreement or disagreement by the respondents. For this reason, responses were first classified by groups and crossclassified as to whether they agreed or disagreed in order to assess the extent of agreement by the respondents. The frequency that respondents checked the "strongly agree" and "agree" columns and "disagree" and "strongly disagree" columns was used as a percentage of the extent of agreement or disagreement.

An examination of Table 11 reveals that 74 percent of the respondents participating in this research project

agreed that the primary objective of financial reporting was to provide useful and relevant information for investment decisions. There was also substantial agreement with respect to the usefulness of the current practice of financial reporting. Eighty-eight percent of management, 88 percent of the CPAs, and 80 percent of the financial analysts agreed that the current practice of financial reporting was useful for making investment decisions. Understandable is that only forecast information would not provide a systematic way in which the investment decisions can be evaluated because there is a time-lag between the point when the investment decision was made and the eventual outcome of the decisions. This inference was supported by the responses with respect to the degree of reliance by investors on the financial statements based on historical-cost data.

The fourth statement asked the respondents to indicate whether investors would continue to rely very much on historical statements, assuming that the current practice of financial statements is the best they have. There was substantial agreement by the respondents. Ninety-one percent of management, 90 percent of CPAs, and 86 percent of the financial analysts agreed on the point.

However, there was less agreement on the statement that forecast information would be more useful for investment decisions than historical information. When asked about the relative importance of forecasts over historical

TABLE 11

EXTENT OF AGREEMENT AND DISAGREEMENT ON GENERAL CONSIDERATION BY MANAGEMENT, CPAs AND CFAs (AMOUNTS EXPRESSED AS PERCENTAGES)

Items	Total			Management			CPAs			CFAs		
	Agree	Unde-cided	Dis-agree	Agree	Unde-cided	Dis-agree	Agree	Unde-cided	Dis-agree	Agree	Unde-cided	Dis-agree
Primary objective of financial reporting	74	5	21	70	11	19	69	-	31	87	3	10
Usefulness of current financial reporting practice	86	4	10	88	4	8	88	4	8	80	3	17
Relative importance of historical over forecasts	51	20	29	50	27	23	45	16	39	63	17	20
Degree of reliance by investors on historical	88	2	10	91	5	4	86	2	12	90	-	10
Relevance of forecast information	43	21	36	27	18	55	65	12	23	30	40	30
Extent of use in currently available forecasts	60	14	26	55	16	29	59	16	25	70	10	20
Reliability of forecasts	25	15	60	20	7	73	29	18	53	27	20	53
Feasibility of auditing forecasts	15	14	71	18	7	75	10	12	78	20	23	57
Legal aspects of forecasts	11	33	56	9	23	68	8	37	55	20	43	37

data, only 51 percent of the respondents agreed that forecasts are more important than historical information. Of the respondents, 20 percent indicated undecided opinions, and 29 percent of the respondents disagreed with the relative importance of forecasts over historical information. Perhaps the lack of agreement among the respondents can be explained by the fact that respondents felt that both historical and forecast information would be equally "necessary" information for making informed investment decisions.

There was also less agreement on the statement that the publication of forecasts would improve inadequate practice of current financial reporting. Only 43 percent of the respondents indicated that the publication of forecasts would improve the inadequacy of current financial reporting practice. Though 36 percent of the respondents disagreed, 21 percent of the respondents indicated undecided opinions. Although the respondents were not directly questioned concerning the inadequacy of the current financial reporting practice, the pattern of the responses, together with the responses on the question of current practice of financial reporting, suggests that the respondents felt a need for an improvement in the current practice of financial reporting (based on historical-cost data).

Despite less agreement on the relative importance of forecasts over historical information, 60 percent of the respondents acknowledged that the currently available

forecasts are being used by some investors for their investment decisions. Seventy percent of financial analysts indicated that investors make extensive use of the currently available forecasts released in the form of press release, president's letters or some other forms.

The final statement included in Part I of the questionnaire inquired as to the attitudes of respondents with respect to the practicality of publication of forecasts. When asked about the feasibility of publishing forecasts from the practical viewpoint of (1) reliability, (2) auditing and (3) legal aspects, there was less agreement than on any other statements asked in Part I of the questionnaire. As can be seen from Table 8, the majority of the respondents either expressed undecided opinions or disagreed with the practicality of publishing forecasts. The practical problems that arise from the publication of forecasts are to be discussed in more detail in the following chapter.

The foregoing analysis of the responses concerning the general consideration of forecasts provides the following conclusions:

1. The primary objective of financial reporting is to provide useful and relevant information for making investment decisions.
2. Historical data are important and necessary for making and evaluating investment decisions.

3. Some forecasts are currently available in one form or another, and investors make extensive use of these forecasts for making their investment decisions.
4. From (1), (2) and (3) above it can be asserted that forecast information should be published.
5. Publication of forecasts involves many practical problems that have to be resolved before implementation of the publication of forecasts.

Comparison of the Present Findings with the Study Reported by Asebrook and Carmichael

As a part of the AICPA research project, R. J. Asebrook and D. R. Carmichael in 1973 conducted a survey of attitudes toward "Accountants' Reports on Forecasts." They mailed out 2,400 questionnaires to 600 randomly selected CFAs, 600 members of the Financial Executives Institutes, and 1,200 practicing CPAs. From this mailing and the second requests they received a total of 864 usable questionnaires, an overall response rate of 36 percent.[3]

For the purpose of their study, a forecast was defined as "a condensed forecast income statement."[4] Hence their definition of forecasts would include such information as forecast sales, gross profits, net operating income before and after taxes, and extraordinary items, all of which are believed to be most likely to occur. With this working definition, their study related to opinion surveys in two major areas: (1) general aspects of the publication

of forecasts and (2) the CPA's involvement with the forecasts.

Although the surveys were conducted as two different research projects, there is a similarity in several respects between the study reported by Asebrook and Carmichael and the current investigation. First, noteworthy is that the research methodology employed was about the same in both studies. Both studies selected random samples of CFAs, CPAs, and members of F E I (or corporate management) with one difference being the sample size. Second, both studies collected empirical data from use of a questionnaire. However, there was a significant difference between the two studies in the content of the questionnaire used. Asebrook and Carmichael were more concerned with the auditing aspects of forecasts and no consideration was given in their study to the financial reporting aspects of forecasts. In a sense, their study was conducted from the auditor's viewpoint. Their study did, however, include a general overview of the subject of forecasts. The second important difference is found in the use of statistical techniques for data analyses. There is no doubt that their study did contribute to the current status of the subject of forecasts, but as a framework for analyses, their study has one significant limitation. It is weak in that no statistical test was used to evaluate mean differences among the groups. Consequently, one cannot tell if the

differences found could be reliable. Studies, which employ multiple dependent variables, as well as multiple independent variables, should use Multivariate Analysis of Variance as the first step in a statistical hypothesis testing. If the overall Multivariate Analysis of Variance test is significant, then Univariate Analysis of Variance can be performed in each dependent variable with confidence that the probability of a Type I error for the univariate tests is close to the value set by the experiment.

Despite the significant differences in the methods of data analyses employed in both studies, a comparison of the results reported by Asebrook and Carmichael with those of the current investigation is meaningful because both studies covered the same subject. The comparison is also meaningful in the sense that the results of the former study can be supported or refuted by the results of this research project. Similar statements and/or questions asked in both studies and the results of responses are compared and presented in Table 12.

When asked about the importance of forecast information, 67 percent of the respondents participating in the current investigation indicated that forecast information is relevant and useful for investment decisions. Whereas 73 percent of the CPAs, 73 percent of CFAs and 55 percent of corporate management participating in the present study agreed that forecast information is useful and

TABLE 12

COMPARISON OF THE PRESENT FINDINGS WITH ASEBROOK AND CARMICHAEL'S STUDY (AMOUNTS EXPRESSED AS PERCENTAGES)

Items	Management			CPAs			CFAs		
	Agree	Undecided	Disagree	Agree	Undecided	Disagree	Agree	Undecided	Disagree
Prejudicial practice	32 (86)	11 (5)	57 (9)	16 (84)	12 (5)	51 (11)	40 (71)	30 (12)	30 (17)
Permissible approach	75 (27)	- (12)	- (61)	76 (49)	- (14)	- (37)	73 (59)	- (11)	- (30)
Requiring publication of forecasts	2 (11)	- (8)	- (81)	10 (24)	- (15)	- (61)	17 (28)	- (17)	- (55)
Competitive disadvantage	64 (40)	18 (20)	18 (40)	14 (20)	36 (17)	80 (63)	7 (13)	27 (19)	67 (68)
Undue reliance by investors	86 (57)	2 (22)	12 (21)	74 (48)	8 (16)	18 (36)	77 (47)	3 (22)	20 (31)
Reliability of forecasts	20 (39)	7 (19)	73 (42)	29 (22)	18 (19)	53 (59)	27 (33)	20 (20)	53 (47)
Management's conservative attitudes	86 (40)	2 (27)	12 (33)	76 (23)	10 (24)	14 (53)	83 (41)	10 (14)	7 (25)

Note: Parentheses indicate the results reported by Asebrook and Carmichael.

relevant, Asebrook and Carmichael reported that 49 percent of CPAs, 59 percent of CFAs, and 27 percent of the FEI members agreed on the importance of forecast information for investment decisions. Although the extent of agreements by the respondents participating in both studies was not the same, the pattern of the responses was similar. In both studies management group indicated the least importance on the forecast information. Noteworthy was that 61 percent of the F.E.I. members that had participated in the Asebrook and Carmichael study indicated that forecast information would not be useful for investment decisions.

Uncertainty hinges upon any prediction about the future, but the very attempt to reduce the degree of this uncertainty is the most important argument advanced for the publication of forecasts. As long as the published forecasts are reasonably reliable, the publication of forecasts would help investors make their informed investment decisions. For forecast information to be useful, therefore, it has to be reliable. The respondents participating in both studies were asked concerning the feasibility of publishing forecasts from the practical viewpoint of reliability. Only 20 percent of corporate management, 27 percent of CPAs, and 27 percent of CFAs participating in the current investigation agreed that forecasts can be prepared with the desired degree of reliability, whereas 39 percent of FEI members, 22 percent of CPAs, and 33 percent of

financial analysts participating in the Asebrook and Carmichael study indicated that the desired reliability of forecasts could be achieved from the practical viewpoint.

Closely related to the reliability of forecasts is the capacity of investors to understand inherent limitations of forecasts. Asebrook and Carmichael asked whether: "the average investor would misunderstand or misinterpret a forecasted income statement published by management."[5] A similar statement was asked in the present study of the respondents as to whether they believe: "Publication of forecasts might mislead and confuse investors because they would place undue reliance on forecasts, despite the inherent uncertainty of forecasts." A substantial number of respondents participating in the current investigation, 86 percent of corporate management, 74 percent of CPAs, and 77 percent of the CFAs, indicated that investors would place undue reliance on forecasts, despite the inherent limitations of forecasts. Asebrook and Carmichael reported that only 57 percent of FEI members, 48 percent of CPAs and 47 percent of financial analysts agreed on the capacity of investors to understand inherent limitations of forecasts.

As presented in Chapter III, forecasts by some companies are currently available in one form or another, and are being used by some investors. The research study sponsored by the Financial Analysts Federation provides the

evidence of this matter. When asked about the general value of management forecasts, 40 percent of the respondents participated in the F.A.F. study replied "valuable," 50 percent of the participants indicated "moderately valuable," and only 5 percent of the respondents answered "slightly."[6] Thus, the empirical evidence provided by the F.A.F. study and the results of the current investigation presented in the preceding section indicate that the forecast information is useful to investors. If forecasts prepared by management are useful, even though the degree of reliability desired may not be achieved, forecasts should, therefore, be made available to the general public. At present, forecasts are made available to some investors, and this prejudicial practice is another important argument for the publication of forecasts. Asebrook and Carmichael asked whether: "disclosure of corporate earnings projections to financial analysts without simultaneous release to the stockholders are prejudicial to stockholders' interests."[7] Substantial agreement on this question showed that 71 percent of CFAs, 86 percent of the FEI members, and 84 percent of the CPAs agreed that it was prejudicial to disseminate forecasts to financial analysts without publishing forecasts to the public. The results of responses on this question thus imply that the current practice of forecasts are prejudicial because some forecasts are made available to some investors. As Asebrook and Carmichael suggested, the

current prejudicial practice could be corrected either by prohibition or by requirement of publication of forecasts. Thus, the question becomes whether publication of forecasts be prohibited, permissible, or required. Asebrook and Carmichael asked the respondents whether forecasts should be either permissible or required. The results of both studies indicated that a very few respondents favored the requirement of the publication of forecasts. However, there was a significant difference between the results of the two studies with respect to the permissible approach. Asebrook and Carmichael reported that 27 percent of FEI members, 49 percent of CPAs, and 59 percent of CFAs agreed with the permissible approach. The results of the current investigation indicate that 75 percent of management, 76 percent of CPAs and 73 percent of CFAs favored the permissible approach. Noteworthy was the fact that 61 percent of the FEI members participating in the Asebrook and Carmichael study disagreed with the permissible approach.

A significant difference was also found in the results of responses concerning a creation of competitive disadvantage. Asebrook and Carmichael reported that the competitive disadvantage was the least important argument against the publication of forecasts.[8] Contrary to the conclusion drawn by Asebrook and Carmichael, 64 percent of the management participating in this research project felt

that the release of forecast information would cause a competitive disadvantage to the corporation. This point was well described by the comment included in a questionnaire by one controller: "If a corporation provides forecast information, it reveals all of its plans and business strategies to allow the competitors to counteract." As this respondent points out, the fear of revealing information that might be helpful to competitors appears to be a very serious concern to the corporate management. As may be noted from Table 7, the mean score for management on the competitive disadvantage is the lowest among the three groups. The lowest mean score for management indicates that they are more concerned with the importance of confidential information.

Of note is the fact that there was a significant difference in the results of responses between the two studies concerning the management conservative attitudes. Asebrook and Carmichael reported that 41 percent of the CPAs, 40 percent of FEI members and 33 percent of CFAs indicated that a corporation would publish understated forecasts so that they can attain readily; however, a substantial number of respondents participating in the present study, 86 percent of corporate management, 76 percent of the CPAs and 83 percent of CFAs, indicated that management would take conservative attitudes toward the publication of forecasts. Because the extent of deviations

of forecasts from actual results (either above or below) can be interpreted as management inefficiency, evaluation of management performance is closely related to the management conservative attitudes toward the published forecasts. If so, contrary to the results reported by Asebrook and Carmichael, the results of the current investigation support an argument that management would prepare conservative forecasts so that they can easily achieve the published forecasts and at the same time reduce the extent of deviations from the published forecasts.

Since Asebrook and Carmichael's study did not include specific questions about the legal problems, other than that of auditing aspects, no direct comparison is possible on this point. However, as noted above, a comparison of the present findings with those reported by Asebrook and Carmichael revealed several differences in the results of responses. There is no way of explaining these differences between the results of the two studies.

Summary

The tests were designed to gather evidence to support the hypothesis that publication of forecasts is desirable. Tests were specifically directed toward the professional "similarity-difference" hypothesis. The tests were conducted in order to see whether the opinions of the corporate management, CPAs and CFAs were significantly different from one another with respect to (1) the general

consideration on the subject of forecasts and (2) advantages and disadvantages of publishing forecasts. The results of the two tests were interesting in that, although there was lack of consensus among the three groups on an overall consideration, the three groups sampled in the current investigation agreed that:

1. The primary objective of financial reporting is to provide sufficient and relevant information for making investment decisions.
2. Current practice of financial reporting based on historical cost is useful for making investment decisions.
3. Investors will continue to rely very much on financial statements based on historical costs.
4. Investors make extensive use of the currently available financial forecasts.
5. Investors would place undue reliance on forecasts, despite the inherent limitations of forecasts.

Following the tests of consensus among the three groups, Principal Components Analysis was performed in order to assess the relative importance of each argument so that the various arguments both for and against the publication of forecasts could be ordered in terms of their importance. Four major factors were extracted and identified. These four factors explained the relationship between the respondents' attitudes and the twelve variables concerning the advantages and disadvantages of the publication

of forecasts. These four factors thus appeared to be of significance to the controversy surrounding the subject of the publication of forecasts. The results of components analysis provided the following implications:

1. The legal liability is an extremely important problem in the implementation of the publication of forecasts.
2. The current practice of financial reporting based on historical data is inadequate for making investment decisions.
3. Corporate management is reluctant toward the publication of forecasts.
4. One of the most important arguments for the publication of forecasts is that forecasts are relevant information for making investment decisions.

Because the results of the two tests (Multivariate Analysis of Variance and Univariate Analysis of Variance) did not indicate the extent of agreement or disagreement by the respondents, except the acceptance or rejection of the null hypothesis, responses were classified by groups and cross-classified to assess the extent of agreement by the respondents. The results of evaluation of the responses on the general consideration of the subject of forecasts provided the following conclusions:

1. The primary objective of financial reporting is to provide useful and relevant information for making investment decisions.

2. Historical data are important and necessary for making an evaluation of investment decisions.
3. Some forecasts are currently available in one form or another, and investors make extensive use of these forecasts to arrive at investment decisions.
4. From (1), (2), and (3) above, it can be asserted that forecast information should be published.
5. Before implementing, publication of forecasts involves many practical problems to be resolved.

Finally, the results of the current investigation were compared with the results reported by Asebrook and Carmichael. The results of the comparison revealed that there was consensus with respect to some items between the two studies. However, the three most significant differences were found in the results of responses concerning: (1) permissible approach of the publication of forecasts, (2) the creation of a competitive disadvantage and (3) management conservative attitudes toward the publication of forecasts. There is no way of explaining these differences between the two studies. Another research study is necessary to explain the differences between the two studies.

FOOTNOTES

[1]Richard J. Asebrook and D. R. Carmichael, "Reporting on Forecasts: A Survey of Attitudes," Journal of Accountancy (August, 1973), pp. 38-48.

[2]Maurice M. Tatsuoca, Multivariate Analysis: Techniques for Educational and Psychological Research (New York: John Wiley & Sons, Inc.), p. 89.

[3]Richard J. Asebrook and D. R. Carmichael, op. cit., p. 39.

[4]Ibid., p. 39.

[5]Ibid., p. 43.

[6]Financial Analysts Federation, Disclosure of Corporate Forecasts to the Investor (New York: Financial Analysts Federation, 1973), p. 149.

[7]Richard J. Asebrook and D. R. Carmichael, op. cit., p. 43.

[8]Ibid., p. 41.

CHAPTER VI

FINDINGS OF EMPIRICAL INVESTIGATION II

A SURVEY OF ATTITUDES

Introduction

As stated in Chapter I, the proposal for publication of forecasts is not attacked on the grounds that forecast information is irrelevant but on the difficulty of implementing publication of forecasts. On the assumption that forecasts would be published, this chapter presents various approaches to the critical problems, and summarizes the corresponding attitudes of the respondents to these problems in the implementation of publication of forecasts. The problem of financial reporting is presented first. Then the problem of attestation of the published forecasts is examined. Finally legal implicatcons are presented.

Financial Reporting

Desirability of Publication of Forecasts

Usefulness of information must meet the test of both relevance and reliability. There is no question about the relevance of forecasts if a forecast is reliable. Reasonably reliable forecasts can help satisfy the investor's

need for information, but unreliable forecasts would not be useful to investors. Central to the issue of publication of forecasts is, therefore, the concept of reliability. When the relevant literature was reviewed, three different views were identified, that is, publication of forecasts should be (1) prohibited; (2) permissible; or (3) mandatory.

The first view is based on the argument that forecasts have inherent uncertainty and thus the degree of reliability does not warrant publication. Unless investors fully understand the limitations of forecasts, the argument continues, they would consider the published forecasts as reliable simply because forecasts are included in published financial statements; therefore, the unreliable information might mislead and confuse investors.

One cannot deny that the possibility exists for misunderstanding the inherent limitations of the forecasts, but the argument cannot be accepted as the equivalent of an argument that publication of forecasts would not be useful.

The second view argues that publication of forecasts should be permissible at the company's discretion. This position is also concerned with the reliability of forecasts. According to this view, publication of forecasts should not be required because most companies will not be able to prepare forecasts with a reasonable degree of reliability. Some companies are of such a nature that they could prepare reliable forecasts while other companies cannot. For example,

forecasts prepared by well-established companies would, in most instances, be reliable for publishing. On the other hand, new companies would have difficulty of preparing reliable forecasts. If there is any reason to believe that many firms within an industry are unable to publish reliable forecasts, this particular industry should be singled out for requirement of publication of forecasts. D. R. Carmichael, for example, takes this position by saying that publication of forecasts should not be mandatory for all corporations. By referring to the experience of profit forecasts in the United Kingdom, Carmichael suggests that the only mandatory requirement that would be feasible would be that a company should either publish forecasts or explain the reasons why forecasts were not published.[1]

Noted was that even the most stable businesses have experienced the deviations of forecasts from actual results. One qualification that has to be made is: What companies should be included and which companies should be excluded within such requirement for publication of forecasts. If permissible, some companies would publish forecasts, whereas other companies, even in the same industry, would withhold publication of forecasts.

With this criticism of the second view, the third view argues that publication of forecasts should be required. Because better informed investment decisions can be made from the comparative information, investors would benefit

more from the full participation of all companies in the publication of forecasts. Those companies which have no operating history or whose earnings are subject to large variation may not prepare reliable forecasts in the same way as the well-established companies. Granted that to prepare forecasts with some qualifications is still possible. Samuel S. Stuart, Jr., Professor of Finance at Columbia University, supports this conclusion by noting that:

> The conclusion of this survey is simple: forecasting is pervasive among firms of all sizes and all industries. While no attempt was made to assess the relative frequency of forecasts by size and industry, it seems obvious that no firm is of a size or an industry group which makes forecasting itself impossible.[2]

With these differing views identified on the desirability of publication of forecasts, the first question asked the respondents was whether forecasts should be published. Table 13 summarizes the results of the responses as to the differing views on the desirability of publication of forecasts.

TABLE 13

DESIRABILITY OF PUBLICATION OF FORECASTS
(Amounts Expressed as Percentages)

	Mgt	CPA	CFA	Total
Should be prohibited	22.7	14.3	10.0	16.3
Permissible	75.0	75.5	73.3	74.8
Mandatory	2.2	10.2	16.7	8.9

Seventeen percent of the respondents opposed publication of forecasts. Noteworthy is that 23 percent of the corporate management participated in this research project were against publication of forecasts. The attitudes of the respondents in opposition to the publication of forecasts are exemplified in the following excerpts (taken from comments on the returned questionnaire):

> The reliability of forecasts is so much subject to question that any use by an outsider must be considered as encouraging irresponsible conclusion.

> Our economic society is very complex. It is subject to rapid and unknown events. An impact on profit of 50% can be caused by a 3%-4% changes in volume, cost and other outside factors.

> Management plans are used for internal planning and control of the business. In my judgement an intelligent investor can make adequate forecasts of the company and industry potentials and general economic trends, very often more intelligently than some management. Publication of forecasts is an area of danger--could be more misleading than useful. I don't think it has been very successful in the United Kingdom.

> Critical determinants of future value are not subject to the data collection and processing theory presently employed by accountants. This means to me that traditional accounting output such as balance sheet and income statement or even innovative or proposed outputs such as forecasts must carry with them the inherent limitations of accounting as a means of determining critical causal relationship necessary for the proper determination of relative future value.

Seventy-five percent of the respondents were in favor of the permissible approach, with 75 percent of the corporate management, 75 percent of the CPAs, and 73 percent of the CFAs indicating desirability to permit publication of forecasts. The following comment made by one

respondent indicates the strong feeling of those who favored the permissible approach:

> Forecasting is desirable, but presently impractical in some industries. Much more study and thought have to be given to the subject. The general approach should be the short-term forecasts only in stable, well-established corporations.

Nine percent of the respondents leaned toward requirement of publication of forecasts, and 10 percent of the CPAs and 17 percent of the CFAs favored this approach. Only 2 percent of the corporate management, however, favored required publication of forecasts. The following comments by the respondents are indicative of the feelings of those who favored the requirement of publication of forecasts:

> Forecast information is helpful when this figure will have a direct bearing on future earnings and so they should be included in the financial statements. A comparison of forecasts with actual results would be most useful.

> The publicly-held corporations have usually a suitable history of operating results and better trained staffs in the company, and they also use in most cases internal budgets information for planning and control of business activities. Why not then require publication of forecasts? If the publicly-held corporations are said to be incapable of preparing reliable forecasts, that of itself would be valuable information to investors.

Considering the pattern of the responses, there are two possible alternatives to the publication of forecasts, that is (1) companies are permitted to publish forecasts or (2) publication of forecasts should be required of all publicly held corporations.

As presented in Chapter III, the S.E.C. took the first lead toward publication of forecasts. The Commission

decided not to require corporations to publish forecasts; instead it proposed to permit corporations to include forecasts in filings with the S.E.C. under certain standards in which the corporation had been a reporting company for a reasonable period of time and that it had a history of earnings and of internal budgeting.[3] The results of the responses thus lead one to conclude that publication of forecasts should be made at least on the permissible approach at this point in time and move gradually toward requirement of publication of forecasts. The general feeling of the respondents suggests that a period of experimentation seems to be desirable.

Presentation of Forecasts

Informational Content

If publication of forecasts is desirable, the next question appears to be the informational content of the published forecasts. Little research has been done as to what and how much information an investor needs for his informed investment decisions. Accordingly, then, simply advanced is that forecast information is useful and relevant because investment decisions are based on future expectations. John C. Burton, the former Professor of Accounting at Columbia University, reported:

> Of those who believed in published forecasts some advocated a full set of predicted financial statements for a period of time into the future, while others suggested a more general forecasts of a range of earnings per share and identification of the critical events.[4]

The fundamental problem becomes the specification of informational content for published forecasts.

The respondents were asked to indicate what information should be included in the published forecasts. Three possible answers were given to the respondents: (1) only forecast earnings per share; (2) specific information (i.e., sales, before- and after-tax earnings, etc.); and (3) forecast conventional statements.

Only 17 percent of the respondents indicated that the inclusion of forecast earnings per share would satisfy the investor's need for information. This position taken by these respondents appears to be based on the belief that investment value depends primarily upon the expected earnings which are the main source of cash dividends and growth potential.

The remaining respondents, however, felt that presentation of forecasted earnings per share is a useful starting point, but may not meet all investors' needs. Admitting that only forecasted earnings per share is not sufficient, all information may not be equally useful and relevant from the standpoints of all users. Although the respondents were not asked to list the specific information which they would like to have from the published forecasts, 60 percent of the respondents placed the greatest importance on the specific information such as sales, before- and after-tax earnings.

Although more than one half of the respondents desired more specific information, only 23 percent of the respondents suggested that forecasted information should be extended to the equivalent of the basic financial statements.

How Forecasts Should Be Recorded

After being asked the informational content of the forecasts, the respondents were next asked to indicate how forecast information should be recorded. Five possible answers were given to the respondents, that is (1) in narrative of a company's general expectations; (2) in a single estimated figure; (3) in ranges or probabilities; (4) in percentage changes; and (5) other. Thirty-seven percent of the corporate management indicated that the forecasts be expressed in narrative. However, 58 percent of the respondents believed that forecasts be recorded as a range of dollar figures. Recording of forecasts in a specific dollar figure lay between these two extremes.

Format of the Published Forecasts

Closely related to the question of recording forecasts is the established standard of presentation of forecasts. Ideally, published forecasts should meet certain uniformity as to format. Many suggestions have been advanced as to the format of presentation for forecasts.

One view argues that forecasts should be presented

side by side along with the historical data so that actual results and forecasts can be compared. S. Davidson, the former Dean of the School of Business of the University of Chicago, proposes that comparative financial statements be converted into three columns: last year's results, the current year's results and the forecast for the next year.[5] The advantage of this approach is that forecasts are directly tied in with historical data, so that it would be helpful in assessing the reliability of current forecasts. The side-by-side presentation approach is not, however, without its disadvantage. If forecasts are presented along with the historical data, the possibility of confusion exists in the use of historical and forecast data, and the result would be to the detriment of the effective use of both informations. Wallace E. Olson, the Executive Vice-President of the A.I.C.P.A., suggests that the "format of a forecast should be as clearly distinguishable as possible from that of historical financial statements and should convey the basic uncertainty of a forecast."[6] Still others argue that forecasts should be presented in a separate report, rather than as a part of the conventional statements since the degree of reliability is significantly different between historical and forecast data.

These three differing views were given to the respondents as the possible approaches to the format of presentation of forecasts. They were then asked to indicate

which of these three approaches they thought was the most desired format of presenting forecasts, with 37 percent of the respondents indicating that forecasts should be presented as distinct from the historical data. The remaining respondents were divided about equally as to the side-by-side presentation approach and a use of a specific report.

The Period to Be Covered

What would be the appropriate period for published forecasts from the viewpoint of reliability and usefulness to investors? This was another question directed to the respondents. One respondent noted that "this question depends on the desired degree of reliability. It is true that the longer the period covered, the greater the potential for errors and the lesser the reliability of forecasts." As this respondent points out, the respondents were expected to balance between the reliability and the usefulness of the forecasts to answer this question.

Ten percent of the respondents felt that forecasts for the coming three-month period would be the most useful and reliable, though another 19 percent of the respondents favored a six-month period. However, the usefulness of the short-term forecast is considered limited. Investment theory suggests that the value of an investment in common stock is the present value of all expected earnings into the indefinite future. However, because money has time

value and the uncertainty increases as the futurity increases, forecasts of long-term duration are impractical. Nonetheless, the earning power of a company cannot be adequately judged on the basis of short-term forecasts. Of the respondents, 15 percent indicated that forecast period should be extended to two-year period, and 10 percent of the respondents favored a period of over two years. Between these two extremes, 46 percent of the respondents indicated a one-year period would be the most useful in making informed investment decisions.

Details of the Assumptions To Be Disclosed

Forecasts are predicated on certain assumptions. The assumptions may be keyed to expected recurrence of the past experience, to new or changed levels of activity or a combination of both. Therefore, varying forecasts are possible, depending on what assumptions are used in preparing forecasts.

Each company has its own particular assumptions such as expansion of plant, introduction of new products, research and development, price changes and so on. Assumptions are also necessary in preparing forecasts as to the industry in which the company belongs, such as the industry trends, market share, and the industry outlook. Finally, assumptions must be made as to the macro-economic activities (i.e., population growth, disposable income, and investment activities). All these assumptions are necessary in quantifying and preparing forecasts.

The question relates to the details of the assumptions to be disclosed. The respondents were asked to indicate whether the assumptions used in the preparation of forecasts should be disclosed, and if so, how much. Only 3 percent of the respondents indicated that the disclosure of the assumptions used in the preparation of forecasts would confuse investors and thus should not be disclosed. However, the remaining respondents favored the disclosure of the assumptions although no agreement was reached as to the extent of details to be disclosed. The following comment made by one respondent indicates the importance of disclosing the assumptions:

> For management purposes the forecasts have been used to make their decisions, they do have value. However, management in using them knows the basis upon which forecasts have been prepared. This information in the hands of the public without explanation of the assumptions upon which they were prepared would lead to very misleading interpretation.

Thirty-six percent of the respondents favored the disclosure of only general economic and industry assumptions with the reservation of the detailed assumption of the particular company involved. Particularly, 62 percent of the corporate management declined to disclose the detailed assumptions of the company. The comment made by one controller is interesting and suggestive:

> To forecast with any accuracy, management would have to consider heretofore undisclosed areas of development that the disclosure could defeat. The present stockholders are also investors and deserve to be protected.

If this comment is typical of the feeling of this group of the corporate management who made reservation of the disclosure of the company's detailed assumptions, the evidence of the least interest in disclosing the detailed assumptions could be attributable to a competitive disadvantage.

Sixty percent of the respondents felt that the disclosure of the detailed assumptions would be desirable for effective use of the forecasts. Contrary to the decline indicated by corporate management, a substantial number of the financial analysts indicated that detailed assumptions should accompany the published forecasts. One financial analyst writes:

> A forecast is not complete unless it includes critical assumptions. The assumptions underlying the forecasts are as important as the published forecast itself because investors can judge how management reached the published forecasts by evaluating the stated assumptions.

Revision of the Published Forecasts

Even though management exercises every effort in trying to arrive at an accurate forecast, forecasts are at best informed estimates about the future. There always exists a possibility that forecasts could deviate substantially from the actual developments. This inherent uncertain nature of forecasts thus raises the question of whether published forecasts should be revised.

Need for and Frequency of Revision

The assumptions on which the forecasts are based are subject to constant changes. Therefore, changed conditions would affect the assumptions and, in turn, the amount of the published forecasts. As the Financial Executives Institute study put it, "even the most highly sophisticated forecasts contain uncertainty and are subject to frequent revision."[7] Unless the published forecasts are revised in response to the changed conditions, the reliability of the published forecasts would be questionable and the investor would be misled.

The respondents were asked to indicate whether forecasts should be revised when the changing circumstances might demand the revision of the published forecasts, and if so, how often. Ninety-six percent of the respondents indicated that the published forecasts should be updated. A large number of the respondents also added that immediate revision of published forecasts would be desirable whenever "material" changes occurred. Though the concept of materiality was not sought, the concept of materiality appears to apply to the changed condition in which management has reason to believe that the published forecasts would require more than modest revision.

As to the frequency of revision, a very small number of the respondents preferred either semiannually or annual revision of the published forecasts. However, most

respondents (72 percent) indicated that the quarterly revision was the most desirable.

Acceptable Degree of Deviation

Following the question of the need for revision of forecasts, the respondents were asked to indicate the degree of an acceptable deviation of the published forecasts from actual developments, with 50 percent of the respondents indicating a 5 to 10 percent range would be acceptable, whereas 34 percent of the respondents indicated a 10 to 20 percent range. Also, 8 percent of the respondents indicated over 20 percent range as acceptable.

Media Selection

The final question asked in the area of financial reporting was: If revision of the published forecasts is necessary, how should investors be informed?"

Only 1 percent of the respondents indicated special meetings with financial analysts as a preferred medium for informing investors of the revision of the published forecasts. Forty-seven percent of the respondents indicated that reports to stockholders would be the most desirable means for informing investors of the changed conditions and the corresponding revision of the published forecasts. In addition, 39 percent of the respondents also suggested the press release as a possible method by which the revision of the published forecasts could be conveyed. The results

of the responses thus enhance the results obtained from the question of frequency for revision of the published forecasts, that is, published forecasts should be updated periodically, preferably quarterly, but the published forecasts should be revised immediately whenever the changed conditions demand the material revision. The results of the responses thus imply that the stockholders should be informed of the revision as the published forecasts are revised, but that the press release could be useful for handling material changes within the period.

Attestation to the Published Forecasts

Prerequisite to Attestation

Need for Attestation

The first question was directed toward asking whether an audit of forecasts by a third party was necessary. As presented in Table 14, fifty-two percent of the respondents felt that audits of forecasts were unnecessary.

TABLE 14

NEED FOR ATTESTATION
(Amounts Expressed as Percentages)

	Mgt	CPAs	CFAs	Total
Unnecessary	56.8	42.9	60.0	52.0
Limited audits are necessary	29.5	34.7	23.3	30.1
Comprehensive audits are necessary	13.6	22.4	16.7	17.9

The following comments made by respondents are representative of their points of view:

> I doubt forecasts can be meaningfully audited by CPAs.
>
> It is impossible to certify the management assumptions.
>
> An audit of forecasts must await establishment of ground rules and currently cannot be contemplated in near future, though an increased credibility of forecasts may be unquestionable.
>
> If forecasts are required, there are many problems ahead such as high costs and conflicts of interests.
>
> To have an accountant or other "expert" review, the forecasts would only compound the problem by adding more appeal to the forecast. . . . Forecasts are at best guesses and to have even the possibility for legal recourse if your guess is wrong. . . . I believe that the average investor would not view forecasts in this light but would tend to view them as actual results to be achieved. For this reason I would tend to oppose any attempt to review forecasts by a third party.

The respondents who considered the review of forecasts unnecessary are apparently basing their opposition on the grounds that if forecasts were accompanied by a review by a third party, the public might assume that a forecast is as reliable as historical data, and thus attestation could possibly encourage an unwarranted confidence.

Without the review by a third party, however, the published forecasts could be biased or intentionally optimistic, pessimistic, or possibly result in deliberate manipulation. Wallace E. Olson, the Executive Vice-President of the AICPA, points out that "because of the high potential for abuses, forecasts should not be circulated without a third party review."[8] A number of procedures can be

followed that would add to the credibility of forecasts. Some principles of auditing forecasts have to be developed, and given this requirement, the review of forecasts would enhance the credibility of forecasts. The remaining respondents shared this argument, although they did not reach an agreement as to the extent of audit by a third party.

Thirty percent of the respondents indicated that limited audits were necessary for "detection of errors in data compilation and checking of accounting bases as to consistency in the preparation of forecasts." One of the typical comments made by the respondents reads as follows:

> There seems to present no special problems of verifying calculations or accounting bases upon which the forecasts are based. The limited review would very likely lead more credibility to forecasts than no review at all.

As the preceding comment indicates, this group of respondents feels that the review of forecasts by a third party would increase the credibility of the forecasts. However, they seem to question whether a third party can objectively verify the assumptions used in the preparation of the forecasts.

Eighteen percent of the respondents indicated that the limited audits would not be sufficient, but that a review of forecasts cannot be complete without evaluating the reasonableness of the assumptions used by the management in the preparation of forecasts. The following comments made by respondents indicate a strong feeling about the

support for a comprehensive audit of forecasts:

> It is an accepted practice in the United Kingdom that an independent accountant must be satisfied with the assumptions of the forecasts before he renders an opinion, though the profit forecasts are the responsibilities of the company's directors. This is not to say that the British practice should be adopted in this country. I believe, however, the grounds underlying the forecasts must be examined and reported by an independent accountant.
>
> In my opinion a review of forecasts should extend not only to the review of data compilation and checking accounting bases but also to the identification of clearly unreasonable assumptions. This extended review of forecasts would result in a third party's opinion that the representation by the management to the public is fairly stated.

Who Should Set the Standards

As noted from the results of the responses concerning the desirability of attestation to the published forecasts, the lack of an agreement by the respondents would appear to be the lack of standards necessary for the audit of forecasts. Since the present auditing standards are basically related to the review of historical data, formulation of standards and guidelines oriented to the audit of forecasts seems necessary.

Given the assumptions that the review of forecasts by a third party is desirable, the second question asked of the respondents was: Who should set the standards of audits? As Table 15 indicates, more than one-half of the respondents (51 percent) indicated the Financial Accounting Standards Board was considered to be the appropriate body, relative to setting standards of audits. Also noted were

TABLE 15

WHO SHOULD SET THE STANDARDS OF ATTESTATION
(Amounts Expressed as Percentages)

	Mgt	CPAs	CFAs	Total
Corporate management	30.4	2.0	10.0	14.2
FAF	2.2	-	13.3	3.9
SEC	13.0	9.8	33.3	16.5
FASB	50.0	64.7	26.7	50.4
Other*	4.3	23.5	16.7	15.0

*Those who checked "other" column indicated AICPA or combination of the above.

that 30 percent of the corporate managers participating in the present study indicated that management should establish the standards and guidelines necessary for the review of forecasts.

Who Should Be Best Qualified

The respondents were invited to supply their opinion as to the question: Who should be the best qualified as a reviewer of forecasts? Though many experts could be contemplated, the respondents were given four alternatives: (1) experts in forecasts, (2) a financial analyst, (3) an independent CPA, and (4) other.

Although 20 percent of the respondents indicated that the expert in forecasts would be the best qualified, a substantial majority of the respondents, 57 percent of the corporate management 76 percent of the CPAs and 53

percent of the financial analysts, indicated an independent CPA as the best qualified for the performance of the attestation function. The recognition of the CPA's qualifications as a reviewer of forecasts is indicated by the following excerpts made by two respondents:

> In fact the large accounting firms are currently performing the management consultant service in the area of forecasts. Although the CPAs do not have the extensive knowledge and experience in all phases of business, I believe general qualifications can be relied upon and his mature judgment would be sufficient to assume the responsibility of the review of forecasts.

> An independent CPA is especially fitted for the review of forecasts because he possesses the review skills, the knowledge of accounting principles, the familiarity with the business operations and the characteristics of the industry and most importantly, his professional status to minimize management manipulation.

The pattern of the responses thus indicates that the CPAs should be the most competent and proficient in the review of forecasts.

CPA's Involvement in Forecasts

The Question of Credibility

Given the assumption that the review of forecasts by a third party is desirable and that the CPA is considered to be the best qualified to perform attest function, the respondents were asked concerning whether the public's interest would be best served if an independent CPA were involved in forecasts.

Twenty-eight percent of the CPAs, 48 percent of the corporate management and 40 percent of the financial

analysts answered "no", whereas 21 percent of the corporate management, 49 percent of the CPAs, and 27 percent of the financial analysts felt that such was the case if the CPA were involved in forecasts. A substantial number of the respondents, 32 percent of the corporate management, 22 percent of the CPAs, and 33 percent of the CFAs, indicated undecided opinions.

The Problem of Independence

Since the purpose of attestation is to increase the credibility of information through impartial review, the reviewer must be sufficiently independent. Respondents were asked whether an audit of forecasts by an independent CPA would impair their independence in connection with their future audits. Of these respondents, 42 percent indicated "slightly" or "not at all" with 31 percent of the respondents indicating "moderately," and 26 percent indicating "very much." Of the CPAs, 51 percent indicated that their independence would be impaired very slightly.

Considering the results of the responses, a majority of the respondents felt a CPA's involvement in forecasts would not cause the problem of independence, although the majority of the CPAs themselves felt it would.

The CPA's Reporting Obligations

Another question asked was "What would be the reporting obligations by an independent CPA if he were involved

in the forecasts?" Three possibilities given to the respondents were: (1) he should not express an opinion on forecasts, (2) he may report on data compilation (arithmetical accuracy, consistency in the application of accounting principles and adequacy of disclosing the relevant information), and (3) he may report on both data compilation and the reasonableness of the assumptions used in the preparation of the forecasts.

Twenty-three percent of the respondents felt that the CPA should not express any opinion on the forecasts. Also, 37 percent of the respondents indicated that the CPA should report on only data compilation, but 40 percent of the respondents indicated that the CPA's reporting obligation should be extended to both data compilation and the reasonableness of the assumptions underlying the forecasts.

The fourth reporting standard of generally accepted auditing standards requires that the auditor's report should clearly indicate the degree of responsibility he is assuming. This requirement thus leads to the consideration of what responsibility a CPA should assume if he is expected to report on forecasts. The respondents were asked to indicate their opinions as to the responsibility the CPA would assume if he were to extend his role to include forecasts. The results were that 20 percent of the respondents indicated "no responsibility," but 30 percent

felt that the CPA should assume the responsibility on both data compilation and the reasonableness of the assumptions. The remaining respondents, 46 percent of the corporate management, 49 percent of the CPAs and 51 percent of the financial analysts, indicated that the CPA's responsibility should be limited to the data compilation.

One may argue that merely checking the data compilation of the forecasts would not increase the credibility of the published forecasts significantly. The argument may also be that the evaluation of, and the reporting on the assumptions used in the forecasts, would not be practical without the established standards and guidelines necessary for the audits. Some assumptions could be subject to a reasonableness test, but there may be practical difficulties in defining the concept of reasonableness. In the United Kingdom chartered accountants review only compilation of the data and the consistent adherence to accounting principles used in the forecasts. They are not required to report on the reasonableness of the assumptions.[9] An accepted practice in the United Kingdom is that the chartered accountants must be satisfied with the assumptions of the forecasts before reporting on forecasts. While the written report of chartered accountants does not indicate the acceptance of responsibility for the assumptions, the chartered accountants believe that they have some responsibility and thus qualifies his report if the assumptions

are not reasonable.[10]

The preceding statements should not be interpreted to mean that the British practice should be adopted in this country, but this practice provides some insight in establishing standards and guidelines. The reporting accountant may deny the achievability of the published forecasts. If so, the reporting accountant can report on the assumptions by specifically stating that the management is solely responsible for the achievability of the forecasts. With this speculation, the respondents were asked the following question: "when the CPA does not agree with the assumptions made by the management, what should be his best course of action?" In answer, 45 percent of the corporate management indicated that the CPA should qualify his opinion when he did not agree with the underlying assumptions, though 18 percent of the respondents felt that the reporting accountant should render an adverse opinion, and 20 percent of the respondents suggested disclaimer of opinion. Only 9 percent of the respondents felt that the reporting accountant should disassociate from his client.

Comparison of the Results Reported by Asebrook and Carmichael with the Current Investigation

Under the assumption that forecasts are published and the CPA would be involved in the reporting of forecasts, Asebrook and Carmichael attempted to assess the attitudes of the respondents with respect to two approaches:

(1) Approach I (Data compilation only) and (2) Approach II (both data compilation and evaluation of the assumptions underlying the forecasts).[11] Both approaches were based on the three important propositions which are: (1) critical assumptions made in the preparation of forecasts should be disclosed as an integral part of the statements, (2) the CPA should be required to perform minimum tests to satisfy himself that the forecasts were prepared consistently with the underlying assumptions, and (3) if the CPA believes that the forecasts lack substance, he would insist upon revision of the forecasts or he would withdraw from the forecasts. The only difference between the two approaches lies in the nature of the opinion the CPA renders. For the Approach I, the CPA renders an opinion on data compilation and the use of consistent application of accounting principles as used in the historical data. For Approach II, the CPA would be required to express an opinion on data compilation and the consistent application of accounting principles, plus his evaluation of the assumptions underlying the forecasts.

With this description of the two approaches and the three important propositions, their study conducted a survey of attitudes concerning the two approaches. As presented in Chapter V, because the content of the questions asked in the current investigation is different from that used in the study by Asebrook and Carmichael, no direct item-by-item

comparison was possible. However, the three items in the area of attestation are of a particular interest for comparison.

The first item in question is consensus about the usefulness of reports on forecasts by CPAs. When the respondents were asked whether the reporting by the CPA on forecasts would serve a useful purpose, 21 percent of the FEI members, 33 percent of the CPAs, and 40 percent of the CFAs showed favorable attitudes. In contrast, 16 percent of the FEI members, 49 percent of the CPAs, and 40 percent of CFAs showed unfavorable attitudes. As presented in the preceding section, the results of the current investigation indicated that 21 percent of the corporate management, 49 percent of the CPAs and 27 percent of the CFAs had favorable attitudes toward the CPA's involvement in forecasts, but 47 percent of the corporate management, 29 percent of the CPAs, and 40 percent of the financial analysts indicated that such was not the case.

The CPA's qualifications for performance of the attestation function on forecasts were included in another similar question asked in both studies. Asebrook and Carmichael provided the respondents with the following statement: "Generally speaking, CPAs possess the necessary competence." In response to this statement, a majority of CPAs believe that the CPA possesses these qualities with respect to the Approach I, but that a majority of the FEI

members do not. With respect to the Approach II, 29 percent of the FEI members, 46 percent of the CPAs and 31 percent of the CFAs agree that the CPA does have the necessary competence, though 57 percent of the FEI members, 38 percent of the CPAs, and 45 percent of the CFAs do not. Although the current investigation did not ask the same question, both Approach I and Approach II were implied in asking "Who should be the best qualified for the audit of forecasts?" The results were that 53 percent of the respondents who returned the questionnaire in the current investigation indicated that the CPA would be the best qualified for the performance of attestation function on the forecasts. Especially, 76 percent of the CPAs, 57 percent of the corporate management and 53 percent of the financial analysts considered the CPA as the best qualified.

The final item for comparison is the question of independence. As presented in the preceding section, the results of the current investigation show that a majority of the respondents expressed that the CPA's independence would be impaired either moderately or very slightly. Especially, 34 percent of the management, 51 percent of the CPAs and 40 percent of the CFAs indicated that the CPA's involvement would impair his independence in connection with his future audits very slightly. Of the CPAs who participated in the current investigation, 6 percent indicated "not at all" in reply to the indepence question.

On the other hand, Asebrook and Carmichael reported that 55 percent of the FEI members, 50 percent of the CPAs, and 47 percent of the CFAs agreed that "he would still appear to be independent in a subsequent audit of historical data covering the same period as the forecasts," whereas 47 percent of the FEI members, 34 percent of the CPAs, and 32 percent of the CFAs felt it would interfere with independence.

Legal Implications

Legal liability is another important item--perhaps the most serious and critical from the practical point of view--in the implementation of publication of forecasts. As in the case of other areas in the proposal for publication of forecasts, there are many positions taken with regard to the problems of legal liability associated with the subject.

The position taken then would be that there would be no new and real problem involved in the implementation of the publication of forecasts if legal liability is limited to recklessness or bad faith. This position is based on the theory that forecasts are inherently uncertain and thus it is not reasonable to impose the liability on the "honest" forecasts.[12] Following this, forecasts are merely opinions made by management concerning future uncertainty. As long as the average investor understands the inherent uncertainty of the forecasts, there should be no additional problems.

Another position would argue that the present system of legal liability should be amended. Especially section 11 and section 12 of the 1933 Securities Act should be amended to exclude liability from the publication of forecasts.[13] Th Wheat report noted specifically the potential for legal liability by the following remarks:

> Even if projections were not required but only permitted, it was observed that problems of civil liability would be insurmountable unless projections in prospectuses were expressly granted immunity from sections 11 and 12 of the Act.[14]

Other groups would argue that potential for legal liability would be increased if the forecasts were published. Testimony presented by E. O. Vetter, the Vice-President of the Texas Instrument, Inc., before the S.E.C. public hearings on the matter of publication of forecasts, illustrates this point of view:

> The tremendous potential for legal liability of the company, its directors and officers, should a required forecast turn out to have misled investors, leads us to object very strongly to any requirement that forecasts be published. We see no way to avoid at least being subject to having defend law suits even if we were ultimately successful in all of them. We accept the possibility of liability if our historical records of sales and earnings are inaccurate, but the fact that these have been evaluated by independent "experts," the CPA, provides a better assurance of accuracy. However, it is questionalbe whether any experts have the ability to evaluate plans or forecasts in any depth.[15]

Regardless of the position taken, the results of Chapter V indicate that it is likely that the average investor would place undue reliance on forecasts which he may believe to be accurate and reliable. If so, the potential

for legal liability would appear to be a realistic constraint in the implementation of publication of forecasts.

Attitudes toward Legal Liability

When the respondents were asked whether they would be in favor of the publication of forecasts if there were no legal liability involved, 46 percent of the respondents answered "yes," while 33 percent of the respondents objected to the publication of forecasts. Particularly interesting were that 57 percent of the corporate managers participating in the current investigation opposed the publication of forecasts, even though no legal liability was involved. However, 49 percent of the CPAs and 63 percent of the CFAs were in support of the publication of forecasts if there would be no legal liability accompanied by the publication of forecasts.

The respondents were again asked to indicate whether they would be in favor of the publication of forecasts if there were legal liability. This question was intended to assess the relative importance of legal liability the respondents could have. Not surprisingly, the pattern of the responses was significantly changed. Only 21 percent of the respondents favored the publication of forecasts with the accompanying legal liability, though 26 percent of the respondents expressed undecided opinions. More than one half of the respondents, 72 percent of the corporate management, 45 percent of the CPAs, and 37 percent of the

financial analysts were in opposition to the publication of forecasts when legal liability was involved. The following comments made by the respondents are indicative of the general feeling of those who expressed serious concern about the potential for legal liability:

> There are still too many problems to be resolved on forecasts.
>
> As an independent CPA, we are much concerned about the potential for liability we might acquire if we were to review forecasts.
>
> Members of the public accounting profession are not likely to receive with enthusiasm the responsibility of attesting to financial forecasts, particularly in view of the current trend of court cases that have arisen from auditing and certifying to the "facts."
>
> We will make our forecasts public as soon as the S.E.C. will resolve the legal liability question.

The results of the responses, together with the foregoing comments, indicate that the potential for legal liability would be a serious concern to the respondents.

Who Should Be Held Liable?

The critical question thus becomes: who should be held liable--management, CPAs, or financial analysts? If determined that investors had been misled or the forecasts were inadequate, there would always be the possibility of legal liability against the preparer and/or the reviewer. The potential of heavy legal liability is thus a part of the environment in which management and CPAs must encounter.

The respondents were asked to indicate their opinions as to "Who should be held liable if an investor made a

decision based on forecasts and the published forecasts were not met by actual developments?" The replies revealed that 17 percent indicated that corporate management should be held liable, whereas 2 percent indicated financial analysts. Only one corporate executive felt that the CPA who reviewed the forecasts should be held responsible. Then, also, 13 percent of the respondents felt that no one should be held responsible (even though such answer was not provided on the questionnaire). As presented in Table 16, 65 percent of the respondents stated that the investor should be responsible for his investment decisions.

TABLE 16

WHO SHOULD BE HELD LIABLE
(Amounts Expressed as Percentages)

	Mgt	CPAs	CFAs	Total
Management	9.1	28.6	10.0	17.1
CPA	2.3	-	-	0.8
CFA	4.6	2.0	-	2.4
Investor	72.7	53.1	73.3	65.0
All of the above	-	4.1	-	1.6
No one	11.4	12.2	16.7	13.0

The following comments made by the respondents illustrate the general feeling of those who indicated that the investor should be held responsible:

> An investor should be willing to take risks if he expects to make profits.

I feel that investors are too well protected now by S.E.C., state agencies and all other quasi-public organizations. Any further effort to create new legislations for disgrantled investors is taking too hard a viewpoint.

Company management should be held accountable for accomplishments--not guesses. We do well at the former, but we are less than proud of our ability at the latter. If the investor expects to increase his returns beyond that of a mere lender of money, he must realize that the excess is a reward for his risk-taking (i.e., his making the forecasts). If he wishes to transfer this risk to management (and perhaps to the auditors) then they should be compensated for the risk--not the investors.

The Possible Manipulation

Those who are responsible for the preparation of forecasts must understand that they may be held liable for the reliability of the forecasts. Several respondents, however, did not take this position. If the forecasts are clearly labelled as such, and prepared in good faith, and if the management has a reasonable basis in light of the information available (or known) at the time the forecasts were prepared, management should be free from the legal liability associated with the published forecasts. One respondent, for example, noted that "there should be no liability in connection with forecasts not met by actual developments unless forecasts were intentionally or negligently prepared." Another respondent referred to the Monsanto Chemical case and commented: "liability must be decided by courts. If forecasts were properly and honestly prepared, there should be no liability."

The delicate problem does exist, however, as one

respondent asked: "How do you differentiate between "honest" wrong guesses and "culpable" deception?" R. Gene Brown made a similar remark as follows:

> With regard to the legal liabilities of management and boards of directors, the publication of formal projected financial statements cannot help but increase legal exposure. Financial performance specifically better or worse than that projected seems clearly to be a source of action for damages. In any situation where a deliberate intent to mislead were established, the same avenues for redress as now exist could be available to third parties. The murky area is when performance differs significantly from plan and there has been an honest attempt to (1) plan properly and (2) make full disclosure, and (3) manage the company as efficiently as possible in a dynamic environment. The recognition of this potential new source of legal complication is one of the reasons why management is not particularly enthusiastic about publishing detailed forecasts in the form of projected financial statements.[16]

If management is liable for the deviation of the forecasts from actual results, and if there is no way of avoiding the liability associated with it, one could contemplate that corporate management could manipulate both forecasts and actual results to avoid the criticisms by investors and thereby reducing the potential for legal liability.

To a question inquiring whether "management manipulate both forecasts and actual results because of potential for legal liability involved and fear of criticism by investors," 24 percent of the respondents disagreed with the question, and 22 percent of the respondents indicated undecided opinions. One controller added the following comment in opposition to the possible manipulation by management:

> Probably the least responsible reporting company would be the most optimistic and have the most attractive forecasts. They would have the least to lose in both credibility and financial resources, since they might have little or none of either.

Fifty-four percent of the respondents, specifically 59 percent of corporate management, 53 percent of the CPAs, and 47 percent of the financial analysts, agreed that the management could manipulate both forecasts and actual results in order to avoid the criticisms by investors with regard to the deviations of the published forecasts. The following notes provided by the respondents indicate their points of view concerning the possible manipulation by management:

> Independent auditors who are legally responsible for a forecast would have the same incentive as management to play down differences in the actual results.

> There is likely the pressure upon management to make short-range decisions which are adverse to long-term corporate goals in order to have published forecasts equal actual results.

Summary

The first area of investigation presented in this chapter was the acceptable way of presenting forecasts for external reporting purposes. A majority of the respondents were of the opinion that reporting of forecasts should be based on the following guidelines in order to be more practical and meaningful:

1. Forecast information should include specific information rather than either the projected earnings per share

or forecasted conventional financial statements.

2. Forecast information should be presented in ranges, rather than in estimated figures or other means.
3. The format of presenting forecasts should be left to the issuing corporation. However, forecasts should be presented as distinct from the historical ata.
4. Forecasts should be limited to one-year period to be most useful and reliable in making investment decisions.
5. To the extent possible, the major assumptions underlying the forecasts should have to be disclosed in details.
6. The published forecasts should be updated periodically, preferably quarterly, but the published forecasts should be revised immediately whenever the changed conditions demand material revision.
7. Stockholders should be informed of the revision as the published forecasts are updated, but the press release can be useful for handling the revision of material changes within the periods.

The second area of investigation presented in this chapter was the critical problems relative to the attestation of forecasts. The results of empirical data indicated that a substantial portion of the respondents participating in the current investigation felt that forecasts could not be meaningfully audited by a third party. Other than inherent limitations of the forecasts, lack of established standards appeared to be a major cause for disagreement

shown by the respondents. Even with the general feeling of the respondents that forecasts could not be reviewed meaningfully by a third party, the present study inquired about important questions relative to the audit of forecasts, given the assumption that forecasts were to be published and audited by a third party. A majority of the respondents participating in the current investigation were of the opinion that:

1. Financial Accounting Standard Board was considered to be an appropriate body relative to setting standards of auditing forecasts.
2. The CPA was considered the best qualified for performance of attestation function of forecasts.
3. A CPA's involvement in forecasts would not cause the problem of independence in connection with his subsequent audits.
4. The reporting accountant should at least report either data compilation or both data compilation and the reasonableness of the underlying assumptions.
5. When the reporting accountant does not agree with the assumptions made by the management, he should qualify his opinion, or render an adverse opinion, or express a disclaimer of opinion.

Finally, this chapter presented the results of the responses relative to the legal implications associated with the publication of forecasts. When the respondents

were asked whether they would be in favor of the publication of forecasts if no legal liability was involved, 49 percent of the CPAs, and 63 percent of the CFAs were in support of the publication of forecasts. However, 57 percent of the corporate management participating in the current investigation were against the publication of forecasts. The pattern of the responses thus indicated that a legal liability was another important, perhaps the most serious from the practical point of view. Given the assumption that publication of forecasts should be accompanied by a legal liability, the present study further attempted to assess the attitudes of the respondents. The majority of the respondents were of the opinion that:

1. They were in opposition to the publication of forecasts when legal liability was involved.
2. If an investor made a decision based on the published forecasts and the published forecasts were not met by actual developments, the investor should be held responsible for his decision.
3. Management could manipulate both forecasts and actual results in order to avoid the criticisms by investors with regard to the deviations of the published forecasts.

FOOTNOTES

[1]D. R. Carmichael, "Reporting on Forecasts: A U.K. Perspective," Journal of Accountancy (January, 1973), p. 43.

[2]Financial Analysts Federation, Disclosure of Corporate Forecasts to Investors (New York: Financial Analysts Federation, 1973), p. 80.

[3]Securities and Exchange Commission, Securities Act of 1933 and Securities Exchange Act of 1934: Statement by the Commission on the Disclosure of Projections of Future Economic Performance (Washington, D.C., February 2, 1973).

[4]John C. Burton, "A Report on the Symposium on Ethics in Corporate Financial Reporting," Financial Executive (January, 1972), pp. 30-2.

[5]S. Davidson, "Publication of Budgets: A Forward Step," Reporting in Seventies (Sacramento: California State University, Sacramento, 1972), p. 9.

[6]Wallace E. Olson, "Statement of the AICPA on Estimates, Forecasts and Projections of Economic Performance before the Security and Exchange Commission" (December 11, 1972), p. 22.

[7]Financial Executive Institute, "How Accurate Are Forecasts," Financial Executive (February, 1973), p. 26.

[8]Wallace E. Olson, op. cit., p. 26.

[9]Council of the Institute of Chartered Accountants in England and Wales, "Accountants' Reports on Profit Forecasts," Accountancy (June, 1969), pp. 467-69.

[10]D. R. Carmichael, op. cit., pp. 38-9.

[11]Richard J. Asebrook and D. R. Carmichael, "Reporting on Forecasts: A Survey of Attitudes," Journal of Accountancy (August, 1973), pp. 38-9.

[12]Henry B. Reiling and John C. Burton, "Financial Statements: Signposts as well as Milestones," Harvard Business Review (November-December, 1972), p. 51.

[13] R. Gene Brown, "Ethical and Other Problems in Publishing Financial Forecasts," *Corporate Financial Reporting: Ethical and Other Problems*, ed. by John C. Burton (New York: AICPA, 1972), p. 230.

[14] *Wheat Report* (Chicago: Commerce Clearing House, 1969), p. 96.

[15] E. O. Vetter, "Hearing on Forecasts before the Security and Exchange Commission" (December 8, 1972).

[16] R. Gene Brown, *op. cit.*, p. 231.

CHAPTER VII

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Many writers have proposed that the primary purpose of financial reporting is to provide useful and relevant information for making informed investment decisions. Also proposed is that investors depend, to a great extent, on future expectations as a major aspect of making investment decisions. If these two propositions are valid, investors should use financial statements as a basis for prediction about the future.

One of the significant criticisms about the current financial reporting takes the form of a statement to the effect that financial statements do not provide statement users with sufficient and relevant information in assessing a company's future aspects. The increasing number of investors, both individual and institutional, points to the need for published financial forecasts as additional information. Whereas the demand for financial forecasts is evident, its extent is not. Furthermore, the likelihood that publication of forecasts may be broadened and effectively enforced has raised many questions. Efforts were thus necessary to determine the extent to which

forecast information is in fact (1) needed by investors, (2) reliable for investment decisions, and (3) practically feasible for the implementation of the publication of forecasts.

Scope of the Research

Given the assumption that forecasts are prepared by corporate management, the present research project investigated theoretically and empirically the following proposed question: Is the publication of forecasts feasible? Specifically, the present study focused on the following selected critical areas:

1. evaluation of the adequacy of current financial reporting practice;
2. identification of the major arguments advanced both for and against the publication of forecasts;
3. investigation of the acceptable way of presenting forecasts for external reporting purposes;
4. examination of practicality of attestation to the published forecasts;
5. examination of legal problems associated with the publication of forecasts.

Library research was done to identify and clarify theoretical aspects of the subject essential to the research. Conceptual attention was given to the primary purpose of financial reporting, the relationship between a share-price model and forecasts, and identification of

conflicting viewpoints concerning the publication of forecasts. Also examined was the current practice of forecasts.

Then, the questionnaire was developed, tested, and mailed to the selected sample of the population. The questionnaire was directed to securing a comprehensive sampling of views of preparers, auditors, and users of financial statements on the question of costs and benefits of the publication of forecasts. For this purpose, the population was defined as consisting of these groups: the management of the members of Fortune 500 U.S. Largest Industrial Corporations, practicing CPAs, and Chartered Financial Analysts. Seventy from each group were selected as a sample of each group. One hundred twenty-three usable questionnaires were received, giving an overall response rate of 59 percent. Ninety-six percent of the respondents who returned the questionnaires had at least five years of experience in their fields. The number of usable responses, together with the assurance that the respondents had sufficient experience in their fields and knowledge of the subject, appeared sufficient for analyzing empirical data for drawing meaningful conclusions about the current status of the publication of forecasts.

Summary

In the long-run, the theoretical value of a stock is a function of current and expected future earnings discounted at some rate of interest. When the simplifying

assumption of perfect certainty is removed, the share-price model becomes complicated because an element of uncertainty enters into the model. Evaluation of investment decisions thus requires (1) estimating the amount of expected future earnings and (2) choosing an appropriate discount rate. However, these two elements usually cannot be readily determined. The investor is thus interested in financial forecasts because expected future earnings information is surrogate to the projected stock price. If the relationship between a share-price and forecasts are as such, and if the primary purpose of financial reporting is to provide useful and relevant information to facilitate investment decisions, publication of forecasts can be argued or at least justifiable on the following two propositions:

1. Investment decisions are based on future expectations; therefore, information about planned or expected future operations of the company is important and relevant to the investor.
2. Information about the future is not available from conventional statements. To accomplish the primary purpose of financial reporting, financial information about expected or planned operations of the company should be included as a part of the published financial statements.

From the theoretical viewpoint, the publication of

forecasts is desirable. Presently, however, a considerable amount of controversy exists as to the practical difficulties in the implementation of the publication of forecasts. Major arguments advanced in opposition to the publication of forecasts are: (1) the capacity of investors to understand inherent limitations of forecasts, (2) the creation of a competitive disadvantage, (3) the potential for legal liability, (4) management conservative attitudes toward forecasts, (5) the potential dangers of manipulation, (6) the incremental costs, and (7) a general loss of investors' confidence in financial reporting.

There are also many arguments in support of the publication of forecasts. Major arguments advanced for the publication of forecasts are: (1) the relevance of forecast information for investment decisions, (2) inadequacy of historical information for investment decision-makings, (3) current prejudicial practice, (4) evaluation of management performance, (5) meaningfulness of management forecasts as compared to those prepared by financial analysts, and (6) efficient resource allocation.

To gain a further insight into the subject, the current practice of forecasts was examined. Because the financial reporting in this country has been influenced mainly by the American Institute of Certified Public Accountants, the American Accounting Association, and the Securities and Exchange Commission, the positions taken

by these organizations were examined. Their traditional positions were that they have been reluctant to have forecasts disseminated to the public. However, the Securities and Exchange Commission has changed its long-standing policy of forecast prohibition. The Commission took the initiative to implement a further step toward an extension of corporate disclosure of forecasts. The experience in profit forecasts in the United Kingdom was then examined. The British experience in forecasts, such as the changing attitudes of chartered accountants toward reporting on forecasts and the accuracy of forecasts, has been most encouraging. The current practice of forecasts in this country was also examined. The analysis of the current practice of forecasts in this country provided some evidence that forecasts are currently made available in one form or another.

Although the review of literature and the evaluation of current practice led to the conclusion that publication of forecasts is desirable, one must consider whether the results of such a theoretical investigation can provide a basis for determining whether publication of forecasts would be practically feasible.

The empirical investigation focused on the testing of the hypothesis that financial forecasts should be published publicly. The test was specifically directed toward the professional "similarity-difference" hypothesis

to gather evidence to support the hypothesis that the publication of forecasts is desirable. The first hypothesis tested was whether the opinions of the three groups are significantly different from one another with respect to the general considerations on the subject of forecasts. The null hypothesis for the multivariate test was rejected. The second hypothesis tested was whether there was any consensus among the three groups with respect to the advantages and disadvantages of the publication of forecasts. The lack of consensus was even more significant. The results of the two tests thus led to the conclusion that the proposal for publication of forecasts could not satisfy all interested groups at this point in time.

Principal Components Analysis was then performed to extract the important factors from the twelve variables on the advantages and disadvantages of the publication of forecasts. The results of the components analysis provided the following implications:

1. Legal liability is an extremely important problem in the implementation of the publication of forecasts.
2. Management is reluctant toward the publication of forecasts.
3. Financial statements based on historical-cost are inadequate for making and evaluation of investment decisions.
4. Forecast information is relevant for making investment decisions.

Following the statistical analyses of the empirical data, views of preparers, auditors, and users of financial statements on the critical areas of financial reporting, attestation and legal implications were sought. The results of findings indicated that 74 percent of the respondents participating in the current investigation agreed that the primary purpose of financial reporting was to provide useful and relevant information for investment decisions. There was also substantial agreement that information on past accomplishments was useful for evaluation of investment decisions. A substantial number of respondents also acknowledged that the currently available forecasts are being used by some investors for investment decisions.

Concerning the question of whether forecasts should be published, 17 percent of the respondents opposed. Whereas 9 percent of the respondents leaned toward the requirement of publication of forecasts, 75 percent of the respondents were in favor of the permissible approach, with 75 percent of the corporate management, 75 percent of the CPAs, and 73 percent of the CFAs indicating the desirability to permit the publication of forecasts.

Although 17 percent of the respondents indicated that the inclusion of forecast earnings per share would satisfy the investor's need for forecast information, 60 percent of the respondents favored the specific information

of forecasts, such as sales, before- and after-tax earnings. Also evident was the fact that 58 percent of the respondents felt that these specific forecast information should be recorded as a range of dollar figures, with 46 percent of the respondents indicating that specific information for the coming year would be the most useful in making investment decisions. Then, also, 60 percent of the respondents felt that the disclosure of the detailed assumptions would be desirable for effective use of the forecasts. However, there was less agreement among the respondents as to the format of forecasts. Whereas 37 percent of the respondents indicated that forecasts should be presented as distinct from the historical data, the remaining respondents were divided about equally as to the side-by-side presentation and a use of specific report.

Furthermore, 46 percent of the respondents indicated that the published forecasts should be revised in response to the changed conditions, preferably quarterly. As to the acceptable deviation of the published forecasts from actual results, one half of the respondents indicated a 5 to 10 percent would be acceptable. About one-half of the respondents also indicated that reports to stockholders would be the most desirable means for informing investors of the changed conlitions and the corresponding revision of the published forecasts.

As to the need for attestation to the published

forecasts, 52 percent of the respondents felt that audits of forecasts were unnecessary. However, 30 percent of the respondents indicated that the limited audits were necessary for detection of errors in data compilation and checking of accounting bases as to the consistency in the preparation of forecasts, and 18 percent of the respondents indicated that a review of forecasts cannot be complete without evaluating the reasonableness of the assumptions used by the management in the preparation of forecasts.

The lack of an agreement by the respondents concerning the need for attestation appeared to be the lack of standards necessary for the audit of forecasts. Since the present auditing standards are basically related to the review of historical data, formulation of standards and guidelines oriented to the audit of forecasts seemed necessary. By 51 percent, the respondents indicated that the Financial Accounting Standard Board was considered to be the appropriate body relative to setting standards of forecasts.

Concerning the question of who should be best qualified as a reviewer of forecasts, a substantial majority of the respondents, 57 percent of the corporate management, 76 percent of the CPAs, and 53 percent of financial analysts, indicated the CPA as the best qualified for the performance of the attest function. There was also a substantial amount of agreement among the respondents as to the

question of the CPA's independence, with 42 percent of the respondents indicating that the CPA's independence would be impaired "slightly" or "not at all," and 31 percent indicating "moderately." However, there was less agreement as to the CPA's reporting obligation, as evidenced by 23 percent stating that the CPA should not express any opinion on the forecasts, with 37 percent indicating that the CPA should report only on data compilation. Even so, 40 percent indicated the CPA's reporting obligation should be extended not only to the data compilation but also to the reasonableness of the assumptions underlying the forecasts. There was also less agreement as to the CPA's best course of action when he did not agree with the assumptions made by the management. Though 18 percent of the respondents felt that the reporting accountants should render an adverse opinion, 20 percent suggested a disclaimer of opinion, with only 9 percent indicating that the reporting accountant should disassociate from his client.

Finally attitudes of the respondents toward the legal liability were sought. The result was that 46 percent of the respondents favored the publication of forecasts if there were no legal liability involved. Noteworthy was the fact that 57 percent of the corporate management opposed the publication of forecasts even when no legal liability was involved. The pattern of the responses was significantly changed when the respondents were asked

whether they favored the publication of forecasts when legal liability was involved. Only 21 percent of the respondents were in favor of the publication of forecasts with the accompanying legal liability.

Despite the results of the responses concerning the legal liability, there were a substantial number of respondents who felt that the investor should be responsible for his investment decisions when based on forecasts. There was also a substantial amount of agreement by the respondents that the corporate management could manipulate both forecasts and actual results in order to avoid the criticisms by investors with respect to the deviations of the published forecasts from actual results.

General Conclusions

Apparently it is difficult to satisfy all those who are interested in the proposal for the publication of forecasts. As noted from the results of the returned questionnaires, the extreme positions taken by certain respondents indicated a strong difference of opinions. The three groups sampled in the current investigation did not have a reaching of minds as to the publication of forecasts. Particularly, corporate management seemed reluctant to publish forecasts to the public because they are concerned with the criticisms by investors about the deviations of the published forecasts from actual results and because corporate management also believed that the publication of

forecasts would create a competitive disadvantage. Excluding the extremes, however, the general conclusions follow when the results of the empirical data were carefully examined and evaluated.

The primary purpose of financial reporting is to provide investors, both present and potential, with sufficient and relevant information to facilitate investment decisions. Because investment decisions are based on future expectations, information about planned or expected operations of the company should be published as a part of financial reporting. Information about the past accomplishments of the company is also essential for evaluation of investment decisions. Because of many unresolved problems, the current practice of financial reporting based on historical-cost appeared to be refined to meet the primary purpose of financial reporting.

Even though 75 percent of the respondents favored the permissible approach of the publication of forecasts, a substantial number of respondents felt that forecasts could not be meaningfully audited by a third party. Other than the inherent limitations of forecasts, lack of established standards appeared to be a major cause for disagreement shown by the respondents.

One strong argument advanced against the publication of forecasts was that unless management (possibly an auditor when associated with forecasts) is given protection

against the deviations of the published forecasts from actual results, exposure to legal liability would be increased. The pattern of the responses strengthened this argument. Only 21 percent of the respondents favored the publication of forecasts with the accompanying legal liability. The legal liability thus appeared to be the most serious problem that has to be resolved before the implementation of the publication of forecasts.

Recommendations

As a result of the study, the following recommendations are made:

1. That the publication of forecasts should be permissible at the company's discretion and move gradually toward the requirement of the publication of forecasts. A period of experimentation seems desirable.
   a. To be practical and more meaningful,
      (1) Forecast information should include specific information, rather than either the projected earnings per share or forecast conventional financial statements.
      (2) Forecast information should be presented in ranges of dollars, rather than in estimated figures or other means.
      (3) Format of presenting forecasts should be left to the issuing corporation. However, forecasts should be presented as distinct from

historical data.

(4) Forecasts should be limited to one-year period to be most useful and reliable for making investment decisions.

(5) To the extent possible, the major assumptions underlying the forecasts should be disclosed in detail.

(6) The published forecasts should be updated periodically, preferably quarterly, but the published forecasts should be revised immediately whenever the changed conditions demand material revision.

(7) Stockholders should be informed of the revision as the published forecasts are updated. The press release can be useful for handling the revision of material changes between the periods.

b. Establishment of auditing standards and guidelines oriented to forecasts is essential.

(1) The Financial Accounting Standards Board should formulate standards of auditing forecasts.

(2) Once standards and guidelines are established, a CPA should perform the attestation function.

(3) The reporting accountant should at least report either on data compilation or on both data compilation and the reasonableness of the

assumptions used in the forecasts.

c. If an investor made a decision based on the published forecasts and the published forecasts were not met by actual results, the investor should be held responsible for his decisions.

2. That emphasis should be placed on a broader education on forecasts. The investor, as well as the corporate management, should have a broader understanding of the usefulness and limitations of forecasts. A broader education for the most unsophisticated investors is essential because they have very little understanding of the inherent limitations of the forecasts, and thus they would tend to accept the published forecasts at face value. A broader education is also essential for corporate management to realize that a corporation has an obligation to disclose forecast information and the public has a right to have the published forecasts.

3. That further research be undertaken. A followup study should be made in the near future. As noted from the comparison of the results of the present findings with the results reported by Asebrook and Carmichael, there were several differences in the results of responses. There is no way of explaining these differences. Other research is essential to draw a definite conclusion regarding the differences in the results of the two studies. Further research is also recommended for the

role of forecasts in investment decisions and for the possible impact of forecasts upon stock market prices.

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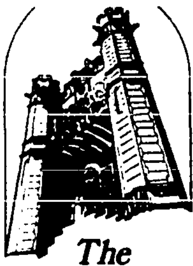
APPENDICES



The University of Oklahoma 307 West Brooks, Room 200 Norman, Oklahoma 73069

Department of Accounting
College of Business Administration

Dear Sir:

I am a doctoral student in the Department of Accounting, University of Oklahoma. I am now writing a dissertation on the subject: "Publication of Financial Forecasts." A critical part of this study is to obtain empirical evidence with respect to opinions of a randomly selected sample of CFAs, CPAs and management.

Enclosed with this letter is a confidential questionnaire. You will note that the questionnaire has been designed so that it will only take a moment of your time to check those answers which best describe your responses to the questions.

It is not necessary that you place your name on the questionnaire. This will insure that your answers will be treated in the strictest confidence and that the information will be used in only aggregated totals in my dissertation.

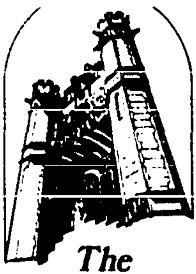
In order for me to complete all requirements of graduation, I must begin statistical analysis of the data as soon as possible. Won't you return this questionnaire in the enclosed stamped return envelope?

Your cooperation in this matter will be greatly appreciated.

Sincerely yours,

Han Ki Min
Special Instructor
in Accounting

Enclosure



The University of Oklahoma 307 West Brooks, Room 200 Norman, Oklahoma 73069

Department of Accounting
College of Business Administration

Dear Sir:

Recently I mailed you an introductory letter and a questionnaire designed to provide information necessary to the completion of my doctoral dissertation. Since the original questionnaire may have been lost in the mail, an additional copy is enclosed for your convenience.

You were selected as one of the special group from the population to participate in this study. I am especially anxious to receive a high percentage of return from the special group to insure that the results of the study provide accurate and useful information.

Since your individual response is critical to the success of this study, I will be most grateful for your answers to the questions appearing on the questionnaire.

If you already responded, please disregard this request.

Your cooperation in this matter will be greatly appreciated.

Sincerely yours,

Han Ki Min
Special Instructor
in Accounting

Enclosure

Department of Accounting
University of Oklahoma, Norman, Oklahoma

CONFIDENTIAL

QUESTIONNAIRE ON
PUBLICATION OF FINANCIAL FORECASTS

INSTRUCTIONS

For each of the following questions or statements, please circle the symbols, or check the box that best describes your opinion. The symbols used in Part I and Part II are:

SA = Strongly agree
A = Agree
U = Undecided
D = Disagree
SD = Strongly disagree

Name: Your name is not to be placed on the questionnaire.
What is your field? ☐ Corporate management ☐ Public accounting ☐ Financial analyst
How many years of experience have you had in your field?
☐ 0 - 5 years ☐ 5 - 10 years ☐ Over 10 years

PART I. GENERAL

(1) The primary objective of financial reporting is to provide relevant and useful information for investment decisions. SA A U D SD

(2) The current practice of financial reporting is useful for investment decisions. SA A U D SD

(3) In making investment decisions, historical financial statements are more useful than forecasts. SA A U D SD

(4) Assuming that there is no solution with respect to the problems of valuation and that the current practice of financial reporting on the basis of historical data is the best we have, investors will continue to rely very much on financial statements. SA A U D SD

(5) Admitted that the current practice of financial reporting is inadequate for evaluation of investment decisions, publication of financial forecasts would help this deficiency. SA A U D SD

(6) Investors make extensive use of the currently available financial forecasts released in the form of press release, the president's letters, or some other form. SA A U D SD

(7) It is feasible to publish financial forecasts from the practical viewpoint of

(7.1) reliability. SA A U D SD

(7.2) verification (or auditing). SA A U D SD

(7.3) the legal aspect. SA A U D SD

PART II. ADVANTAGES AND DISADVANTAGES

(1) Investment decisions are based on future expectations; therefore, information about future operations is the most relevant and useful for investment decisions. SA A U D SD

(2) Publication of financial forecasts might mislead and confuse investors because they will place undue reliance on forecasts despite its inherent uncertainty. SA A U D SD

(3) Circumstances change so rapidly that historical information is not useful as a basis for prediction. SA A U D SD

(4) The release of forecast information would create a competitive disadvantage. SA A U D SD

(5) At present financial forecasts are made available to some restricted investors. Requirement of publishing financial forecasts would eliminate this prejudicial practice. SA A U D SD

(6) Required publication of financial forecasts would increase potential for legal liability in your field. SA A U D SD

(7) Comparison of published forecasts with actual results enables investors to evaluate better management planning ability and their performance. SA A U D SD

(8) Management may tend to be overly conservative for fear of incurring liability. SA A U D SD

(9) Overestimation and deliberate manipulation would be likely in the use of forecasts. SA A U D SD

(10) The attendant disclosure of assumptions would be more valuable to investors than forecasts made by various investment advisors disseminated without explanation. SA A U D SD

(11) The cost of preparing, auditing and revising the published forecasts would be very expensive, as compared to possible benefits to be derived. SA A U D SD

(12) When forecasts are not realized, there would likely be diminished credibility and a general loss of investors' confidence in financial reporting. SA A U D SD

PART III. FINANCIAL REPORTING

(1) In your opinion, publication of financial forecasts should be
- ☐ prohibited.
- ☐ permissible at the company's discretion.
- ☐ mandatory.

(2) What is, in your opinion, the optimum period for a forecast from the viewpoint of reliability and usefulness to investors?
☐ 3 months ☐ 6 months ☐ 1 year ☐ 2 years ☐ other(specify)_______

(3) What information should be included in financial forecasts?
- ☐ Only forecasted earnings per share.
- ☐ Specific information (i.e., sales, before-tax earnings, after-tax earnings, etc.).
- ☐ Forecasted conventional statements (i.e., balance sheet, income statement, statement of changes in financial position).

(4) What is the desired format of published financial forecasts?
- ☐ Side by side presentation of historical and forecasted data.
- ☐ Presented as distinct and be segregated from the historical data.
- ☐ Use of a specific report.

(5) Should the assumptions used in the published forecasts be included?
- ☐ Inclusion of assumptions might confuse investors so they should not be included.
- ☐ Only general economic and industry assumptions should be included.
- ☐ Inclusion of detailed assumptions is more meaningful since investors can evaluate and interpret them.

(6) How should financial forecasts be presented?
- ☐ in narrative of a company's general expectations.
- ☐ in single estimated figures.
- ☐ in ranges or probabilities.
- ☐ in percentage changes.
- ☐ other(specify)_______

(7) What should be the acceptable degree of deviation of forecasts from eventual results?
☐ less than 5% ☐ 5% - 10% ☐ 10% - 20% ☐ over 20%

(8) Changing circumstances might demand revision of published forecasts. How often should the published forecasts be revised or updated?
- ☐ Should not be revised during the period covered by the forecasts.
- ☐ Quarterly.
- ☐ Semiannually.
- ☐ Annually.

(9) If revision of the published forecasts is required, how should investors be informed?
- ☐ Special meeting with analysts.
- ☐ Press release.
- ☐ Reports to S.E.C.
- ☐ Reports to stockholders.

PART IV. ATTESTATION

(1) What is your opinion regarding the audit of forecasts by a third party?
- ☐ Audit is unnecessary and might be misleading.
- ☐ Limited audit is necessary.
- ☐ Published forecasts are considered more reliable when accompanied by the auditor's statement.

(2) Assuming an audit of forecasts is considered desirable, who should set the standards of verification?
☐ Corporate management ☐ F.A.F. ☐ S.E.C. ☐ F.A.S.B. ☐ Other(specify)_______

(3) Assuming an audit should be made, who do you think the best qualified?
- ☐ An expert in forecasting.
- ☐ A financial analyst.
- ☐ An independent C.P.A.
- ☐ Other(specify)_______

(4) Do you think the public's interest would be best served if an independent C.P.A. were involved in forecasts?
☐ Yes. ☐ Undecided. ☐ No.

(5) Assuming an independent C.P.A. is best qualified for an audit of forecasts, what do you think his reporting obligation is?
- ☐ He should not express an opinion on forecasts.
- ☐ He should report only on data compilation.
- ☐ He should report on both data compilation and reasonableness of assumptions.

(6) If an independent C.P.A. does not agree with the assumptions made by management, what do you think his best course of action is?
- ☐ Qualify an opinion.
- ☐ Disclaim an opinion.
- ☐ Give an adverse opinion.
- ☐ Disassociate with a client.
- ☐ Other(specify)_______

(7) To what degree do you think an audit of forecasts by an independent C.P.A. would impair his independence in connection with future audits?
☐ Very much. ☐ Moderately. ☐ Slightly.

PART V. BEHAVIORAL

(1) If there is no legal liability involved, would you be in favor of publication of financial forecasts?
☐ Yes. ☐ Undecided. ☐ No.

(2) If there is legal liability involved, would you still be in favor of publication of financial forecasts?
☐ Yes. ☐ Undecided. ☐ No.

(3) If an investor made a decision based on forecasts, and the published forecasts were not met by actual development, who should be liable?
- ☐ Management who prepared the forecasts.
- ☐ An independent C.P.A. who reviewed the forecasts.
- ☐ A financial analyst who interpreted the forecasts.
- ☐ An investor who acted in reliance of any of the above.

(4) If an independent C.P.A. should extend his role to include forecasts, what should be his responsibility?
- ☐ No responsibility.
- ☐ Underlying assumptions only.
- ☐ Data compilation only.
- ☐ Both underlying assumptions and data compilation.

(5) Because of potential for legal liability involved and fear of criticisms by investors, management may manipulate both forecasts and actual results.
☐ Agree. ☐ Undecided. ☐ Disagree.

PART VI. ADDITIONAL COMMENTS

Please make additional comments and/or suggestions here (if more space is needed, use the reverse side of this page).