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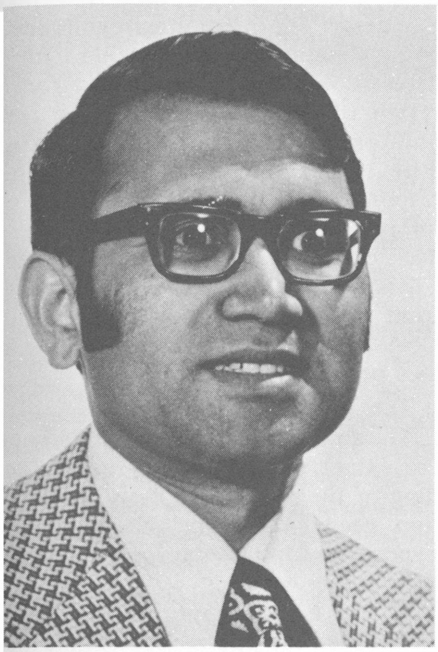

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Bridge To The Market Place

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Of the four important groups engaged in the preparation, use and distribution of corporate annual reports, namely, corporate management, public accountants, security analysts, and the Securities and Exchange Commission, much of the burden of improving disclosure in corporate annual reports rests with the public accounting profession. The profession has been conceded that trust and responsibility both by the reluctance of other concerned groups and by the unique position enjoyed by the public accountants in the United States. However, the success of the profession in bringing about disclosure improvements depends much on its understanding of the users' information requirements. The principal contention of this paper is that at present a lack of understanding exists in the public accounting profession regarding information requirements of the users of corporate annual reports. Both the published literature on the subject and an investigation carried out by this author support the contention.

User Discontent With Corporate Annual Reports

Corporate annual reports provide management with an important vehicle for communication with the outside world. The United States Congress realized the importance of disclosure in corporate reports when it passed the Securities Act of 1933. In fact, the Securities Act has often been called a disclosure statute and its long title reads: "An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof. . .". To administer the disclosure statute, Congress created the Securities and Exchange Commission by an act in 1934. Despite these and other efforts toward improvement the published evidence suggests that corporate disclosure practices have not reached a satisfactory stage. The investors and their counselors are dissatisfied with the published corporate reports and they often resort to sources other than corporate financial statements for needed information.[1] In fact, Roper in his depth interviews with various types of users of corporate statements, even detected bankers and analysts lacking confidence in corporate financial statements.[2]

Management's Reluctance for Disclosure

Time and again the courts have held that the primary responsibility for the accuracy of information filed with the SEC and disseminated among investors rests with management.[3] Management cannot discharge its obligations in this respect by employing public accountants. However, left to its own initiative corporate management is often reluctant to disclose fully and freely to the corporate stockholders.[4] Historically, corporations disclosed very little until the turn of the twentieth century. Of the 957 corporations listed with the New York Stock Exchange in 1926 only 339 corporations issued their annual reports to the stockholders then.[5] Finally, the Exchange made the issuance of corporate reports a part of its regular listing requirements.

There is no doubt the Securities Act of 1933 has improved the quality and quantity of disclosure in corporate reports but only to the extent the Act requires management to comply. For instance, management has an option of filing a copy of annual report in partial compliance with the requirements for financial statements to be included in its 10-K reports. Out of 150 corporations, one recent study found, only 17 corporations exercised this option confirming the difference between the two reports. The study thus commented, "If there are no material differences between two types of reports prepared by corporations, the efforts should not be duplicated by preparing a separate report for the SEC. But a majority of the corporations subject to the SEC filings do not exercise the option, implying that there are material differences between these two typs of reports."[6] A majority of the witnesses appearing before the Senate Committee on Banking and Currency in June 1963 also supported the contention that corporate managements are little inclined to disclose information to investors at their own initiative. Since banks are not subject to SEC regulations, their annual reports are often both inadequate and uniform.[7]

In brief, the dissatisfaction with the contemporary corporate disclosure practices is widespread among the users

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of corporate reports. The principal reason for such a discontent lies in the reluctance of corporate management to disclose adequately unless pressured by legislation or outside forces.

The SEC Reluctance

Though the SEC has been making news in recent months by taking active interest in the development of accounting principles, historically it has played a passive role in prescribing accounting principles. The Securities Act gives the SEC the authority to prescribe accounting principles in filing the financial statements filed with it. However, the commission has not, in general, exercised this authority. In the past the SEC has been content to rely on generally accepted accounting principles as they exist or develop with the passage of time. The Commission has virtually left the task of developing sound accounting principles to the accounting profession. The public accounting profession has often applauded the inactive role of SEC for a variety of reasons.[8] The commission seems to believe the development of accounting principles is in the domain of free enterprise and it encourages the accounting profession to take initiative in this respect. The SEC intervenes only in pressing exceptional situations.[9]

The Dominance of Public Accountants and Security Analysts

Through the years public accounting and security analysis professionals have emerged as the principal spokesmen of the preparer and user groups of published corporate annual reports. The SEC reluctance to invoke its authority to prescribe accounting principles has only increased the responsibility of public accounting profession in this respect. Notwithstanding management responsibility for preparing and distributing corporate reports to the external users, the certified public accountants enjoy the unique privilege of determining what information to present to the stockholders and in what form. They are closest to the corporate management on preparer side and are usually grouped with the preparers of corporate financial statements. They enjoy an immensely important place in the organized capital market and not many corporations venture to publish uncertified financial statements or statements with qualified report from the public accountants. Accountants enjoy what one security analyst calls "a point of leverage" in this respect.[10]

While discussing what each member of the user-preparer group could do to make corporate reports more meaningful Leonard Spacek of Arthur Andersen & Co. found that security analysts, stock exchanges, the SEC, and even corporate management rely on the corporation's public accountant for adequacy and reliability of the financial information provided the investor. He comments, "Thus we have gone the full circle of financial statement responsibility to the investor, and we end up with the public accountant. In the last resort, all others rely on him to justify what is adequate and reliable information for the investor."[11]

On the user side of the corporate annual reports, the security analysts have emerged as the principal surrogates of a vast number of individual and institutional investors. They not only represent investors' information needs but they are themselves major users of corporate financial statements. A vast majority of investors often obtain financial information indirectly via the studies prepared by the security analysts. Further, the analysts counsel on a large proportion of equity investment decisions. Security analysts represent investors because their information requirements are derived from the needs of the investors they advise.[12]

In brief, one finds that of the four principal parties involved in the preparation and use of corporate financial statements, namely, corporate management, the SEC, public accountants and security analysts, the last two share major responsibility. But how effectively the public accountants and security analysts can discharge their respective responsibilities depends on how much they understand each other. The more public accountants understand the security analysts' information requirements, the better they will be able to serve their needs. However, the investigation carried out by the author indicates a lack of understanding between the two professions.

Accountants Understanding of User Information Needs

The author mailed a questionnaire to a group of randomly selected 300 certified public accountants working with the national Big Eight firms of CPAs[13], and to 400 chartered financial analysts to study the extent of public accountants' understanding of users' information needs. The questionnaire contained 58 information items (see table 1 for a list of information items) selected from a review of published literature on corporate accounting and security analysis. The questionnaire asked the respondents to value the significance of information items in equity investment decisions on a five point scale.[14] In all, 339 replies were received (159 out of 300 from CPAs and 180 out of 400 from CFAs) giving an overall response rate of 48.4 percent.

Test Results

The author was interested in studying the extent of accountants' understanding of the security analysts' information needs and tested the following hypotheses from the data collected from the questionnaire:

> There is no significant difference between the public accountants and security analysts on the value of accounting information items for equity investment decisions.

The hypothesis was tested individually for each information item by chi square test at a significance level of 5 percent (a = .05). Table 1 summarizes the test results for each information item. Of the 58 information items tested, the hypothesis was rejected on 37 of those items. The test results revealed a lack of consensus between the two groups on the value of three types of information items.

First, there is a lack of consensus between the two groups on information concerning budgetary disclosures, e.g., planned capital expenditure for next twelve months; planned expenditure on research, development and exploration; planned expenditure on advertising and publicity and cash flow projections.

Second, differences exist on information pertaining to details and breakdowns, namely, amount and breakdown of operating expenses; breakdown of inventory under major categories; investment in each subsidiary company; breakdown of sales, net operating income, income after tax and investment by continent or hemisphere for companies with international operations, and by operating division, product, line of business or customer groups for diversified companies; terms, annual rentals and breakdown of long term leases by the type of property leased, etc.

Finally, consensus is lacking on information items not traditionally reported by corporations, viz., amount expended on human resources; share of market in major product areas; both FIFO cost and market value of inventory; names of top executives, lines of authority and their renumeration.

Since the hypothesis was rejected for the following information items also it seems differences exist between accountants and analysts on a large number of popularly reported information items. The chi-square test value was exceeded for questions about amount of operating expenses reported; cost of goods sold reported; earnings per share reported and the method used in its computation; amount of inventory reported and the method used in its valuation; amount of depreciation reported and the method used in its computation; and amount of goodwill and other intangibles amortized.

The differences between the public accountants and security analysts are not confined to information on projections alone. The two groups extend their disagreements to information items pertaining to the past, such as amount expended on research and development and exploration; reported capital expenditure (additions to physical facilities); rent payment or receipts on long term leases and shareholders' equity and the number of common shares outstanding.

Perhaps the most interesting results were found in the case of the following two popular items in the questionnaire: earning per share reported for the period and the method used in its computation; and the source and application of funds statements for the period. The proposed hypothesis was rejected for both of these items and the lack of consensus on the value of these items was surprising in view of the emphasis they receive in the literature.[15] In accord with past findings the present study also tends to indicate that user and preparer groups continue to be indifferent to price-level adjusted corporate reports.[16]

Conclusion

The principal contention of this paper is that a lack of understanding exists in the public accounting profession as to the information requirements of the users of corporate annual reports. In a competitive economy like that of the United States much burden for improvement in corporate accounting disclosure rests with the public accounting profession. The success of the profession depends on its awareness of users' information requirements.

A lack of understanding between the two professions could be due to a lack of communication between the security analysts and the accountants.[17] Apparently the half-hearted efforts made in the past to bring the two professional groups to a common understanding have not had much effect. Both groups happen to see each other as adversaries rather than as complementary professions; both professions have been harmed by their mutual distrust. Another explanation may lie in the flexibility offered by the prevailing variety of the "generally accepted accounting principles." As long as management can find an acceptable alternative within the GAAP, it can find an approving (and willing) public accountant also.

In a private enterprise economy the public accounting profession shoulders heavy responsibility for developing sound corporate disclosure practices. Corporate management is naturally reluctant to disclose much to the outside world. Regulatory agencies like SEC are also hesitant to intervene for obvious reasons. Independent public accountants not only carry the attest function but are also expected to innovate and improve. However, much of that innovation and improvement depends on understanding the user information — requirements.

Accounting professionals have an impressive array of technical expertise but, as the present study indicates, they seem to be insensitive to the needs of the readers of financial statements. It may be appropriate to suggest that some behavioral insights into user needs are as essential as technical competence.

Half-hearted efforts made in the past to bring accountants and security analysts to a common understanding have not had much effect. Both groups see each other as adversaries rather than complementary professions.

[1]See Corliss D. Anderson, "The Financial Analyst's Needs" in *Berkley Symposium on the Foundations of Financial Accounting*, (University of California, Berkeley, 1967), pp. 98-109; Abraham J. Briloff, *The Effectiveness of Accounting Communication*, Frederick A. Praeger, 1967), pp. 7-54; John C. Burton (ed.), *Corporate Financial Reporting: Conflicts and Challenges*, (American Institute of Certified Public Accountants, 1969), pp. 97-111; Charles T. Horngren, "Disclosure: 1957," *Accounting Review*, (October, 1957), pp. 598-604; Leonard M. Savoie, "Meeting Financial Consumer Needs," *Financial Analysts Journal*, (March-April, 1969), pp. 47-48; and Leonard Spacek, *A Search for Fairness in Financial Reporting to the Public*, (Arthur Andersen & Co., 1969), pp. 313-338.

[2]Elmo Roper, *A Report on What Information People Want about Policies and Financial Conditions of Corporations*, Vol. I, (The Controllership Foundation, Inc., 1948), pp. III-XXVIII. See also, Thomas H. Sanders, *Company Annual Reports to Stockholders, Employees, and the Public*, (Harvard University, 1949), pp. 181-226.

[3]Interstate Hosiery Mills, Inc., 4 SEC 721 (1939).

[4]See Surendra S. Singhvi, "Corporate Management's Inclination To Disclose Financial Information," *Financial Analysts Journal*, (July-August, 1972), pp. 1-8.

[5]Oscar M. Beveridge, *Financial Public Relations*, (New York: McGraw Hill Book Co., 1963), p. 139.

[6]Surendra S. Singhvi, *op. cit.*, p. 2. See Also Surendra S. Singhvi, "Disclosure to Whom? Annual Financial Reports to Stockholders and to the Securities and Exchange Commission," *Journal of Business*, (July, 1968), pp. 347-351.

[7]U.S. Congress, Senate Committee on Banking and Currency, *Hearings Before a Subcommittee*: SEC Legislation, 88th Congress, 1st Session. p. 106.

[8]See Louis H. Rappaport, *SEC Accounting Practice and Procedure*, (The Ronald Press Co., Third edition, 1972), Ch. 3.

[9]*Ibid*, Ch. 3.

[10]See Burton, op. cit., pp. 105, 108 and 144.

[11]Spacek, *op. cit.*, p. 327.

[12]See Horngren, *op. cit.*, pp. 598-604; and James C. Stallman, "Toward Experimental Criteria for Judging Disclosure Improvement," *Empirical Research in Accounting: Selected Studies*, 1969, p. 30.

[13]Namely, Arthur Andersen & Co.; Coopers & Lybrand; Ernst & Ernst; Haskins & Sells; Peat Marwick, Mitchell & Co.; Price Waterhouse & Co.; Touche Ross & Co; and Arthur Young & Co.

[14]The study used the following five point scale: Very Important (VI); Important (I); Neither Important Nor Unimportant (N); Unimportant (U); and Very Unimportant (VU).

[15]See John C. Burton, *op. cit.*, pp. 99-100, 142-144; and Lyn D. Pankoff and Robert L. Virgil, "Some Preliminary Findings from a Laboratory Experiment on the Usefulness of Financial Accounting Information to Security Analysts," *Empirical Research in Accounting: Selected Studies*, 1970, pp. 10-12.

[16]Charles T. Horngren, "Implications for Accountants of the Uses of Financial Statements by Security Analysts," (Unpublished doctoral dissertation, University of Chicago, 1955), pp. 6-7; and Alan R. Cerf, *Corporate Reporting and Investment Decisions*, (University of California, Berkeley, 1961), p. 57.

[17]See Abraham J. Briloff, *op. cit.*, pp. 219-223.

Table 1
Test Results of Hypothesis

	Information Items	Chi Square Statistics	
1.	Total assets reported, end of period (e.o.p.).	7.7083	
2.	Total current assets reported, e.o.p.	5.0329	
3.	Total current liabilities e.o.p.	4.7825	a
4.	Cost of marketable securities, e.o.p.	4.8309	
5.	Market value of Marketable securities, e.o.p.	6.1968	
6.	Amount of revenue and the method used in its recognition (e.g., franchise business, construction firms, etc), for the period (f.t.p.).	0.0113	b
7.	Operating income reported (before non-recurring gains and losses), f.t.p.	1.2890	b
8.	Amount and breakdown of operating expenses reported, f.t.p.	68.4882	*R
9.	Cost of goods sold reported, f.t.p.	12.0396	*R
10.	Earnings per share reported f.t.p. and the method used in its computation.	8.9354	*aR
11.	Compounded rate of growth in earnings per share for the last five to ten years.	3.6031	
12.	Dividened per share on common shares, f.t.p.	1.8909	a
13.	Amount of inventory reported and the method used in its valuation, e.o.p.	9.1538	*aR
14.	Breakdown of inventory reported under major categories, e.o.p.	30.8204	*R
15.	Fifo cost of inventory, e.o.p.	19.0719	*R
16.	Market value of inventory, e.o.p.	34.8953	*R
17.	Amount of depreciation reported and the method used in its computation, f.t.p.	51.4687	*R
18.	Amount of straight-line depreciation on long-lived assets, e.o.p.	82.7123	*R
19.	Amount of accelerated depreciation on long-lived assets, f.t.p.	88.0304	*R
20.	Amount of non-recurring gains and losses reported, f.t.p.	1.5608	a
21.	Amount expended on human resources (e.g., hiring, training, etc.), if material, f.t.p.	14.2516	*R
22.	Amount of past pension fund liability, if material, e.o.p.	16.9462	*R
23.	Accounting method followed for research and development, and exploration costs.	16.6582	*R
24.	Amount expanded on research, development and exploration, f.t.p.	36.4027	*R
25.	Accounting method followed for advertising and publicity costs.	22.4977	*R
26.	Amount expended on advertising and publicity f.t.p.	49.0298	*R
27.	Accounting method (purchase vs. pooling) followed for each acquisition and merger completed during the period.	4.7182	
28.	Amount of goodwill recognized in each acquisition completed during the period.	3.4511	
29.	Amount of goodwill and other intangibles amortized, if material, f.t.p.	19.3622	*R
30.	Amount of income tax expense, f.t.p.	11.3607	*R
31.	Amount of deferred income tax liability or prepaid income tax, e.o.p.	3.2405	
32.	Amount of each subsidiary's earnings and parent company's share of its earnings, f.t.p.	65.2620	*R
33.	Investment in each subsidiary company, e.o.p.	59.9314	*R
34.	Minority interest reported in each consolidated subsidiary, e.o.p.	47.6072	*R
35.	Breakdown of sales, income after tax and investment by continent or hemisphere (where international operations contribute over 15% of company's revenues), f.t.p.	38.3400	*R
36.	Breakdown of sales, net operating income and investment of diversified companies by operating division, product, line of business, or customer group (segmented on the basis of 15% or more contribution to gross revenue or operating income), f.t.p.	51.8965	*R
37.	Reported capital expenditures (additions to physical facilities), f.t.p.	87.0341	*R
38.	Planned capital expenditures for next twelve months.	83.2313	*R
39.	Planned expenditure on research, development and exploration for next twelve months.	40.0120	*R

40.	Planned expenditure on advertising and publicity for next twelve months.	20.5958	*R
41.	Method followed for reporting long term leases, f.t.p.	8.6002	
42.	Rent payments or receipts on long term leases, f.t.p.	40.0490	*R
43.	Terms, annual rentals and breakdown of long term lease by the type of property leased (e.g., real estate, equipment, etc.), e.o.p.	8.8070	
44.	Backlog and projection of orders, e.o.p.	29.3450	*R
45.	Productive capacity and actual output (e.g., steel mills, oil companies, etc.), f.t.p.	40.7108	*R
46.	Extent of dependence on a few customers (e.g., defense contracts, foreign markets, etc.).	7.4112	
47.	Share of market in major product areas, f.t.p.	27.9873	*R
48.	Total common shareholders' equity and number of common shares outstanding, e.o.p.	20.4338	*aR
49.	Number of stock warrants and convertible securities outstanding, e.o.p.	12.2177	*R
50.	Number and type of common shareholders (e.g., individuals, institutions, etc.), e.o.p.	3.6915	
51.	Number of shares in the company owned by its officers, e.o.p.	6.9335	
52.	Terms of stock option plan and shares involved, e.o.p.	9.8494	*R
53.	Amount and breakdown of preferred stock and long-term debt by type, dividend and interest rate and maturity, e.o.p.	4.3399	
54.	Contractual restrictions on common dividened, if any, e.o.p.	9.2978	
55.	Source and application of funds statements, f.t.p.	18.2157	*R
56.	Cash flow projections for next two to five years.	45.6911	*R
57.	Price-level adjusted annual corporate reports as supplementary statements.	5.5317	
58.	Names of top executives, lines of authority and their remuneration.	28.6310	*R

* Significant at 5 percent level.
Degrees of freedom for items marked with 'a': 3
Degrees of freedom for items marked with 'b': 2
Degrees of freedom for other items: 4
R= Rejection Range

APPENDIX

Table 2

Questionnaire Responses and Present Position (Title) of Respondents

Title	CPAs	CFAs
Partner	74	35
Manager	53	26
Supervisor	7	—
Security Analyst	—	58
Salesman	—	2
Others	14	47*
Not Given	11	12
Total responses received (1)	159	180
Questionnaires mailed (2)	300	400
Response rate (1) & (2)	53%	45%

* Includes such titles as Vice-President, Fund Manager, Trust Investment Officer, Executive Vice-President, Consultant, Investment Counselor, President, Portfolio Manager, Assistant Treasurer, Investment Manager, Trustee, etc.