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BASIC QUESTIONS: WHEN ARE WE GOING TO ANSWER THEM?

by A. A. Sommer, Jr.*

In these days, in every area of endeavor, we are questioning the most basic premises upon which we have built our society. More intently than perhaps we have ever done, we are asking what the role of government should be in our society, the extent to which we should look to it for the assuagement of our social and economic problems, and how far it can encroach upon our freedoms in the interest of the "common good". We find economists in sharp disagrement over how to analyze the economy of our nation and how to direct it to produce goods that are compatible with the defined goals of our society. Their problem is compounded by the fact that we are in a massive debate over what those goals should be. After literally hundreds of years of accepting the proposition that a prime goal of our society was the economic betterment of everyone, the production of more goods, the raising of the standard of living of everyone, suddenly

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we are concerned more with the quality of human life than with the quantity of economic goods society affords us, and this is stimulating us into the profoundest of inquiries concerning the nature of man and his society. The professions are not exempt from these searching inquiries. Urgently there are questions raised as to what is the proper role of the lawyer, whether he can continue to be the single-minded advocate of his client indifferent to broader social concerns. And similarly questions are being asked about the role of accountants and the process of auditing. The corporate structure as we have known it is increasingly called in question and the very legitimacy of corporations is stridently argued.

It is probably well that this is happening and peculiarly appropriate that all this discussion is occurring in the bicentennial year of our country. I would like to chop off tonight one small fragment of our total national life and talk a bit in terms of the fundamental questions that relate to that fragment. To most of the people in this country, it probably seems an insignificant part of the total puzzle. To you and to me, and to whose with whom we associate regularly, it is a terribly vital question. It is the question of how our securities markets operate, and more particularly, what is the role of disclosure in those markets.

It is astonishing to realize, but there is every reason to believe it is so, that no official, or unofficial, body for that matter - no one other than individual scholars - has penetrated very deeply into the manner in which information concerning corporate issuers functions in the securities market. There have been occasional surveys and polls in an effort to gain some fragmentary insight into the information that is used by analysts, how disclosure reaches those responsible for making investment decisions and so on. But all of this has been decidedly fragmentary and, in many cases, the methodology leaves a great deal to be desired.

Our concerns with these questions have been sharpened by a good deal of thinking and writing about how the securities markets function. We hear such things as "the efficient market hypothesis" and the "random walk theory" and the "dartboard" theory of securities selection. We hear assertions that, no matter how astute, no fundamental analyst can outperform the market as a whole over an extended period of time, thus leading some to conclude that fundamental analysis with its heavy reliance on information is a waste of time. On the other hand, we hear that essential to the efficiency of the market is the maximum amount of information useful to professional analysts and other sophisticates who express their judgments by action in the market, thereby creating an equilibrium price for a security that is in effect a congealing of all of the information into a number. In the face of these conflicting ideas, what <u>is</u> the role of information in the securities marketplace?

When the Securities Act of 1933 and the Securities Exchange Act of 1934 were anacted, these theories and hypotheses had not yet been shaped, hence they could not have engaged the attention of Congress. Futhermore, it does not appear that Congress made any sort of empirical effort to find out what kind of information users of information would use if available in making investment decisions, or the costs of securing and disseminating such information. They drew in large measure upon their instincts, upon the experience of the British under the Companies Act, limited testimony by investors or would-be investors and the logic of the situation. This was particularly true with regard to the Securities Act of 1933 which included Schedule A which stated the particulars of corporate disclosure, but then gave the Commission broad power to modify or extend those requirements. Since that time, the Commission, acting under the Congressional mandate, has steadily expanded the scope and quantity of disclosure until now we have a system that is being criticized as being unduly burdensome, of little use to investors and generally somewhat creaking. At the same time that the Commission has been mandating significant expansions of disclosure - disclosure with regard to leases, disclosure of the impact of inflation upon replacement cost of fixed assets and upon inventories, more information in interim reports, and so on - there are voices in the land that say all of this and what has gone before are for naught. It is suggested that empirical evidence indicates that investors have not been better protected because of the federal system of disclosure that has been elaborated and it is said that the markets for securities are no better than they would have been had there never been an SEC. While I a~~d~~bjure these extreme viewpoints, nonetheless I cannot be indiffernt to them, coming as they do from respectable, even eminent, economists who have thought long and hard about these matters and in some cases utilized advanced computer technology in an effort to establish an empirical base for their judgments.

I think it is very difficult to quantify the total problem of disclosure or reduce it to elements that can be fed into a computer to produce meaningful conclusions concerning the desirability of the federal disclosure system. However, I think we must, particularly considering the dearth of fundamental research that has gone on with regard to the disclosure system, ask some penetrating questions and seek, to the extent that they can be secured, answers based upon research.

Realizing this, the Commission several weeks ago authorized the organization of an Advisory Committee on Corporate Disclosure for the purpose of examining and securing data with regard to the most fundamental questions we can ask concerning corporate disclosure as it relates to the investment process. To the maximum extent possible, we propose to conduct our study by talking to the people who are involved in this process to determine how it operates and what utility it has. We are not going to rely to a great extent upon lifeless questionnaires, but rather we are going to send members of our staff into the field to explore in depth the manner in which corporate information of purported significance to investors originates with issuers, what it costs to produce and disseminate it, how it is disseminated. We will then follow this information down through channels until it reaches those who have responsibility for making investment decisions - portfolio managers, trustees, individual investors of various sizes and sophistication. We want to find out whether this vast mass of information which is now being produced by American corporations is really being used, and is of use, to those who make investment decisions. The thrust of the study is not only a negative one - to determine which parts of the present disclosure system might be eliminated without interfering with the investment process - but is also a positive one - to determine what information not presently being furnished would be useful. With regard to the latter, in the course of our preliminary research utilizing the experience of various people in the investment process in framing our interview techniques, it has been suggested to us that one of significant pieces of information that analysts might wish to have which they do not presently have is a discussion by the managements of companies about how they view the future prospects and developments of their industries. Similarly it has been suggested that instead of the cumbersome forecasting mechanisms that the Commission proposed last year, there should be simply a discussion by management of how it views the prospects of a company during the next year and the next five years, without perhaps requiring a quantification of expectations.

As I have thought about disclosure problems and how the Committee should approach them, it has seemed increasingly apparent to me that one of our most difficult tasks is going to be avoiding encroachment upon areas of research and investigation which have been charted out by other bodies, particularly the Financial Accounting Standards Board in its study of the conceptual framework of accounting. The questions which that group should be asking are in many respects indistinguishable from the ones that we're asking and it may well be that the audiences to which we direct our inquiries and investigations are the same. Increasingly, I realize that the disclosure system cannot in truth be divided up into an accounting disclosure system and a non-accounting disclosure system. Oh, we may speak of such a dichotomy, but approaching our effort as if such dichotomy were real is a difficult task. It seems to me that this sort of division has become increasingly difficult as more and more of the information required under accounting principles and good accounting practice is expressed, not in numbers and according to accounting conventions, but in footnotes to financial statements which, believe it or not, sometimes exceed in obscurity those portions of disclosure documents prepared by lawyers!

As I ponder our undertaking, I am confronted with some feeling of discouragement that the effort by the accounting profession to arrive at a definition of fundamentals has been so long delayed. I have concluded with considerable reluctance that the process of establishing accounting principles is, and has for a long time been, strangely upended, with prodigious amounts of time being spent on the right problems at the wrong time or in the wrong sequence. No one can quarrel now with the quantity of output by the Financial Accounting Standards Board; in three years it has produced opinions at a rate twice that of the APB. Many do quarrel with the quality of that output and contend that it is not sufficiently reflective of underlying principles, business necessity or consistent logic. In some measure, I think there may be merit in those criticisms, although I freely confess that my technical competence is not such as to be able to nitpick the pronouncements which have emanated so far. My remarks concern not the merits of the individual opinions but rather the sequence in which the work of the Board has been occurring.

For many years the accounting world has been filled with discussions about the basics of accounting: what are the most fundamental premises upon which an accounting system is built? What are the bedrock principles? What are the postulates? What are the assumptions that we must work with, assumptions simply because they are not susceptible of empirical justification? Supposedly one of the reasons for the creation of the Accounting Principles Board almost two decades ago was to permit research into these matters so that opinions with regard to specifics would have an inherent coherence and be parts of a logical, total structure. The committee which recommended this establishment of the APB said it very well in 1958:

> "The broad problem of financial accounting should be visualized as requiring attention at four levels: first, postulates; second, principles; third, rules or other guides for the application of principles in specific situations; and four, research.
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> "Postulates are few in number and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment, and from the modes of thought and customs of all segments of the business community....A fairly broad set of co-ordinated accounting principles should be formulated on the basis of postulates....The principles together with the postulates should serve as a framework of reference for the solution of detailed problems."

As happens too frequently, the necessities of the moment began to take precedence over this longer range objective - in my estimation a far more important project - with the result that the Accounting Principles Board, like the Financial Accounting Standards Board now, began to be judged more by the quantity of its output than its adherence to principles. Thus the Board, after considerable backing and filling, developed such mechanistic monsters as Opinion No. 15 with respect to the reporting earnings per share. The occasion for the demise of the Accounting Principles Board in the minds of many was the harsh dispute over business combinations and pooling which resulted in a severe crisis of credibility. A more basic reason for its demise in my estimation was its failure to do what it was supposed to do: deal with the basic structure of the accounting world.

Once again, as the APB came under greater and greater fire, the accounting profession geared up to do what had been proposed to be done by the Accounting Principles Board - namely, deal with the fundamentals of the accounting process. The AICPA appointed two eminent committees, one to explore what mechanism should be established for the development of accounting principles, and the other, to deal with the objectives of financial statements. Whether planned or by happenstance, the former committee reported first and recommended the establishment of the mechanism. This report was adopted almost in toto by the AICPA and out of that effort came the Financial Accounting Standards Board.

Somewhat later, the Study Group on the Objectives of Financial Statements, the so-called Trueblodd Committee, made its report. The implementation of that report and its further development were passed on to the FASB, which then established a task force for the purpose of studying the conceptual framework for accounting and reporting.

I would suggest that somewhere along the way the process has broken down. From the first moment of its existence the

Financial Accounting Standards Board was concerned with the here and now. Very quickly, in response to its own recogition of needs and also in response to the suggestions of the Advisory Council (of which I was a member at the time), it filled out an agenda of some ten or twelve items which were obviously the ones topmost in the thoughts of those concerned with the pragmatic present of accounting. Thus, currency translation, research and development, accounting changes in interim statements and so on claimed early attention of the Board and the project to develop the conceptual underpinnings of the accounting process became simply another item on the FASB's agenda.

The result is that we have a commendable outpouring of opinions and interpretations from the FASB - all of them infected with little identifiable principle, other than the conviction that there must be one right way for dealing with each problem. Sometimes, it seems to me, these determinations are infected with another principle, these determinations are infected with another principle, namely, select the alternative which will result in less averaging of effects over time, an approach that creates substantial instabilities in reported income. This total approach has within it some severe problems. For one thing, it results in surprises to the market, surprises that are less the result of operating activities of the company than they are the conventions of accounting. Secondly, it has the effect of inviting management to engage in transactions and activities, less because of their economic benefit, than because of the manner in which they will be treated in the income statement.

It may well be that this approach is the only sound one given our investment atmosphere. But then on the other hand, it may well be that, considering accounting as a part of a much larger economic scene, this is a misleading approach. And yet, how can we find that out unless we have an intensive study, a spirited debate and a prompt resolution of fundamental questions concerning accounting? There have been those who have argued - and perhaps, at one time I was one of them - that it was more important to have certainty with regard to accounting principles than it was to have accounting principles that hung together on a tree of fundamentals. That position might be justifiable if the effort to establish underlying fundamentals was progressing at an appropriate pace, but, alas, that pace has lagged.

All of us are gifted with 20-20 hindsight and I apologize if I criticize what has gone before using those handy and sometimes less erring spectacles. I think it would have been far better if, in 1973, the AICPA had allocated a portion of the resources which it committed to the Financial Accounting Standards Board to a separate group which would have had the mandate of fleshing out the Trueblood Committee report when it was completed. Such a group could have been single-minded in its pursuit of the basics. It could have examined, with greater singleness of purpose, the problems of the efficient market, how modern thinking with regard to that impacts disclosure, the manner in which disclosure using the conventional accounting model relates to other kinds of disclosure. Such a group could have pursued in an empirical fashion the relevance of conventional accounting models and the information it displays. It may well be that such a group, using the findings of scholars with regard to markets and the use of information, would have concluded that the energies of the FASB should be more in the direction of greater disclosure and less in the direction of efforts to quantify in a single number the results of an enterprise during an arbitrary period.

While this group was undertaking the consideration of these basic questions, the FASB would of necessity have had to deal with the problems of here and now. In a sense, perhaps, its chore would have been easier since it could, given the existence of another group concerned with the fundamentals, more freely acknowledge that its decisions were not animated by any cohesive principle but were simply pragmatic, perhaps even arbitrary, determinations. Thus it would be understood that the determinations of the Board would be subject to review and such modification as might be necessitated by the conclusions with regard to the basic accounting model.

For too long debate has continued with regard to basic accounting and for too long we have been content with decisions that are unlinked by any fundamental principles or any fundamental conceptions of the purposes financial statements cast in an accounting mold should serve. Some of the questions that the Commission's Committee on Corporate Disclosure proposes to consider are as relevant to the accounting world as they are to the non-accounting world. For instance, what information is useful in the investment process? Those who are vested with the responsibility of making investment decisions - and they have many degrees of sophistication, insight, ability: what kinds of information do they want and what kinds of information do they use? I will grant that some inquiries have been made by the accounting profession in connection with the work of the principle setting bodies -- public hearings are held, submissions are encouraged, and perhaps even some informal conferences are of assistance. However, I think this is an area that lends itself to in depth empirical survey activity, the sort of thing we are endeavoring to do as a part of the Commission's study by talking to innumerable users of information to find out the kinds of information that are useful to them, the modes of presentation which are helpful and the answers to similar questions.

Similarly, it seems to me that any in depth study of accounting must approach the question of the manner in which accounting treatment determines management judgment. I have heard of cases in which management has changed its behavior, sometimes to the economic detriment of the enterprise, because of the pronouncements of the Financial Accounting Standards Board. Does this make sense? Regardless of whether it does, it seems to me that it merits careful consideration by anyone concerned with the fundamentals of accounting and financial reporting. It may well be that no system can be devised which would not result in such behaviorial consequences, but at least the question should be confronted and efforts made to adequately answer it. Accounting is intended to mirror economic activity. There is something backward - and when I say this I realize

I sound very simplistic - about a system in which the image that is intended to be mirrored is in turn shaped by the mirror.

As Chairman of the Commission's Advisory Committee on Corporate Disclosure, I would hope to explore with the FASB means by which their effort to understand the conceptual framework of accounting might be meshed in a meaningful fashion with our effort to discover the ultimate truths of disclosure. It seems to me that their focus should probably be the same as ours, namely, a definition of what users of corporate information need and want. It was suggested in the Trueblood Committee report that perhaps the hallowed notion that a single financial statement could serve the needs of all users of financial information needed reexamination and a system of multiple financial statements, with different orientations, should be developed. With respect to that, I suppose our study is somewhat more limited since we are not concerned with the disclosure requirements imposed upon corporations by institutional lenders such as banks, insurance companies, and so on. We are more concerned with those investors who might be described as "public" and with the manner in which disclosure relates to the organized securities markets. However, the fact that our focus may be somewhat more limited should not preclude the development jointly of meaningful answers.

I would urge accounting leaders to double, triple and quadruple their efforts to develop this conceptual framework for accounting. I would suggest that perhaps, urgent as many of the problems of the FASB are, this effort should yield second place to none. It may well be that instead of trying to arrive at definitive principles the FASB should direct its efforts toward expanding the disclosure required so that investors may themselves make judgments with regard to the potential impact of differing accounting principles. If the effort to solve the fundamentals of accounting yields the conclusion that there should be, wherever feasible, a single accounting principle accepted as authoritative, then the FASB could go on with its work of doing that. When it did, it would have a new and potentially decisive tool to use in its work, namely, fundamental principles, articulated, expressed, understood. I would suggest that when that happens, the credibility of its work and the integrity of its effort will be enormously enhanced.

I am sure that what I have said tonight will be construed as a biting criticism of the FASB and it will be construed as an "authoritative statement" by the Commission. These remarks are neither. When Commissioners say, as we usually do, that we speak for ourselves, not for the Commission, rumors to the contrary, that is literally true. The Commission has not discussed these matters and it has not formulated any position with regard to the desirable priorities of the FASB's work. These thoughts are only mine. But beyond that, I do not want them to be construed as a criticism of the enormously difficult work the FASB has done. It has responded competently to enormous pressures, and I know from personal exposure to the endeavors of the Chairman and the other members of the Board that they are working unstintingly on their tasks. I am only suggesting that perhaps there should be a reexamination of priorities and greater effort accorded to a work which I think is fundamental to their entire endeavor. I wish them well. I know them. I have confidence that they will in all matters be guided only by what they conceive to be the right thing to do.