

T H I R D   E D I T I O N

# FINANCIAL REPORTING

— AN —

# ACCOUNTING REVOLUTION

# WILLIAM H. BEAVER

HINTICE HALL CONTEMPORARY TOPICS IN ACCOUNTING SERIES

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# Financial Reporting: An Accounting Revolution

Third Edition

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Prentice Hall, Upper Saddle River, New Jersey 07458

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#### **Library of Congress Cataloging-in-Publication Data**

Beaver, William H.

Financial reporting : an accounting revolution / William H.

Beaver.—3rd ed.

p. cm.—(Prentice-Hall contemporary topics in accounting series)

Includes bibliographical references and index.

ISBN 0-13-737149-7 (alk. paper)

1. Accounting—United States. 2. Financial statements—United States. I. Title. II. Series: Contemporary topics in accounting series.

HF5616.U5B36 1998

657'.3'0973—dc21 97-25886

CIP

Prentice-Hall International (UK) Limited, *London*  
Prentice-Hall of Australia Pty. Limited, *Sydney*  
Prentice-Hall Canada, Inc., *Toronto*  
Prentice-Hall Hispanoamericana, S.A., *Mexico*  
Prentice-Hall of India Private Limited, *New Delhi*  
Prentice-Hall of Japan, Inc., *Tokyo*  
Simon & Schuster Asia Pte. Ltd., *Singapore*  
Editora Prentice-Hall do Brasil, Ltda., *Rio de Janeiro*

Printed in the United States of America

10 9 8 7 6 5 4 3

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# Preface

As I indicated in the previous editions, I am indebted to the late Sid Cottle, who coauthored *Security Analysis* with Benjamin Graham and David Dodd, for first suggesting that the changes in perspective regarding financial statements were revolutionary. The revolution began in the mid-1960s and a question arises whether it is still appropriate to refer to an accounting revolution. Although the transition is by no means complete, the conceptual shifts in recent years have been milder.

In discussing this issue with others, some suggested that the series of political events in France that began in 1789 is still called the French Revolution, even though the transition to democratic forms of government is largely complete. It refers to a historical period that is dominated by changes in perspective of governance. At the risk of mystifying the younger readers, who have known only the postrevolutionary period, I have decided to still refer to these changes in perspective as an accounting revolution.

Of course, the revolution is not complete, particularly in the regulatory processes for financial reporting. In retrospect, the revolution was much more of an academic revolution and reflected a major shift to an informational perspective accompanied by a substantial explosion of empirical research that adopted an informational perspective. Much of the regulatory rhetoric is still the language of measurement, and recently we have seen an expansion of research that embraces a measurement perspective.

The major changes in this edition are in the last half of Chapter 4 and all of Chapters 5 and 6. Chapter 4 now includes the Feltham–Ohlson framework and discusses key features of financial reporting such as clean surplus, delayed recognition, conservatism, and discretionary accruals. In retrospect, it is striking how much early research and, as a result, the first and second editions were focused on an earnings-

only valuation approach from an informational perspective. The third edition attempts to acknowledge the broader perspective of recent research that incorporates balance sheet as well as earnings variables. Chapter 5 has been updated to reflect recent empirical research that adopts a balance sheet perspective and to discuss the dual book value and earnings valuation studies. Many of these studies adopt a measurement rather than an informational perspective. Chapter 6 has undergone major revisions, largely because of empirical research documenting systematic patterns in security returns, such as the postearnings announcement drift and the forecasting of future returns as a function of the book-to-market ratio.

A major issue in the revision is what recognition to give, if any, to the new millennium. After all, they don't come around very often. I had originally included a lengthy section in Chapter 7 with speculation on financial reporting in the twenty-first century. I am reminded of reading issues of *Popular Science* in the 1950s, which contained ambitious forecasts of what future technology could bestow on us. One issue and the attendant cover I particularly remember contained the prediction that within 20 years (in other words, the 1970s) every suburban home would have its own personal helicopter. Indeed, some prosperous homes would have more. During the morning rush hour, thousands of helicopters would leave their launch pads in the driveways and fill the skies. Traffic jams in the skies would be a major problem. Well, I guess they are around major airports today, but the prediction of a personal helicopter (or two) in every driveway has hardly come to pass.

In retrospect, I do not want the third edition to suffer the same fate as an issue of *Popular Science* from the 1950s. Therefore, I have decided to keep forecasts for financial reporting for the next millennium to a minimum. The concepts underlying the first and second edition are the main focus of the third edition.

I am indebted to many people who have made this and previous editions possible. Their numbers increase, and there are too many to list them all. A special debt is owed to Chuck Horngren and Joel Demski, my colleagues and friends with whom I have shared the Chicago and Stanford experiences. Chuck is now emeritus and Joel has departed for the frontiers of Connecticut and then Florida. However, my debt to them is undiminished. I am also indebted to my colleagues, my coauthors, and my doctoral students, especially Mary Barth, Wayne Landsman, and Stephen Ryan, who have significantly affected my thinking. I also wish to thank P. J. Boardman of Prentice Hall and Katherine Schipper for their encouragement and support in undertaking a third edition. I would also like to acknowledge the helpful reviews of Teresa P. Gordon, University of Idaho; Steven R. Jackson, University of Southern Maine; Frank J. Kopczynski, Plymouth State College; Wayne Landsman, University of North Carolina; and James M. Wahlen, University of North Carolina. My assistant, Bryan Brown, was very helpful in preparing many of the new tables, figures, and revised bibliographies.

Most of all, I am indebted, as ever, to my wife, Sue, and to my children, Marie, Sarah, and David, for their love and support.

William H. Beaver

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# The Revolution

On the eve of a new millennium, financial reporting is a subtle mixture of the old and the new. Double entry accounting is 500 years old and still forms the backbone of the structure of financial statements. Early in the twentieth century, accounting theory evolved into a stewardship theory of how best to measure assets, liabilities, equity, and earnings and compared the accounting measures with economic concepts.

The past 35 years have experienced a rapid growth in the quantity and complexity of financial reporting requirements mandated by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).<sup>1</sup> Both the American Institute of Certified Public Accountants (AICPA 1994) and the Association for Investment Management and Research (AIMR 1993) have evaluated whether the current system is adequate for the challenges of financial reporting in the twenty-first century and have called for significant changes in that system.<sup>2</sup> Many of these proposals, which call for disclosures of nonfinancial data, forward-

<sup>1</sup>The SEC is an independent agency of the federal government created by the Securities Acts of 1933 and 1934. It is empowered to ensure "full and fair" disclosure by corporations. The nature of its activities is described in an excellent text by Skousen (1983). The FASB is a private-sector organization that determines the financial accounting standards to be used in preparing annual reports to shareholders. Throughout, the Statement of Financial Accounting Standards of the FASB are referred to as FAS followed by the number of the standard. The generic term *financial reporting* is used to include financial statements and financial disclosures.

<sup>2</sup>The American Institute of Certified Public Accountants (AICPA) is the professional organization primarily composed of members of the public accounting profession, and the Association for Investment Management and Research (AIMR) is the professional organization primarily consisting of financial analysts.

looking data, and fair market value data, can be viewed as natural extensions and implications of adopting an informational approach to financial reporting. As its implications are pursued, an informational approach can have dramatic effects on the way financial reporting is viewed, evaluated, and regulated. This change in perspective is called a *financial reporting revolution* and is the main subject of this book.

This introductory chapter provides a brief historical perspective on the purposes of financial reporting, with a special emphasis on the objectives of financial statements. The informational approach is then introduced, and the role of accrual accounting from an informational perspective is discussed. The major constituencies and the economic consequences of the financial reporting environment are also described. In presenting this framework, several trends in financial reporting are identified. Key features of the environment are its complexity, diversity, and impact on the preferences of the constituencies for financial reporting.

The selection among financial reporting systems by management or by the financial reporting regulators is a substantive choice, which involves making trade-offs with respect to the effects on the different constituencies. A particular financial reporting requirement is the outcome of a political (or social choice) process.

This chapter provides the basis for understanding the financial reporting revolution and provides a perspective for the remaining chapters, which are briefly summarized at the close of this chapter.

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## 1-1 HISTORICAL PERSPECTIVE

The stewardship function of management was dominant in early views of the purpose of financial statements. Under this view, management is the steward to whom capital suppliers (in other words, shareholders and creditors) entrust control over a portion of their financial resources. In this context, financial statements provide a report to capital suppliers that facilitates their evaluation of management's stewardship. A variety of reporting systems could conceivably fulfill this purpose. However, in financial accounting it has long been presumed that merely reporting cash flows is inadequate and that some form of accrual accounting is appropriate.

This basic faith in the superiority of accrual accounting is epitomized in Paton and Littleton's (1940) monograph, which focuses on the *matching concept*. This monograph has been called one of the most important contributions to financial accounting of the twentieth century.<sup>3</sup> The matching concept states that revenues and expenses should be recorded such that efforts and accomplishments are properly aligned. Reporting cash receipts and cash disbursements will not properly match, and some form of accrual accounting is called for. Accrual accounting is essential to proper financial reporting. However, the accrual process is ambiguous and not well-

<sup>3</sup>American Accounting Association Committee on Concepts and Standards for External Financial Reports (1977).



defined. For example, for virtually every major event that could affect the financial statements of a firm, there exists a variety of alternative methods for matching costs and revenues. LIFO versus FIFO methods of inventory valuation and straight-line versus accelerated methods of depreciation are two prominent examples within the framework of historical cost accounting. Departures from historical cost accounting, such as various forms of current cost and market value accounting, further increase the alternatives available. The question then arises as to which accrual method is "best." This question has been viewed as essentially a normative one.

One approach to evaluating alternative accrual methods is to attempt to infer criteria from general definitions, such as *net income*. Net income can be defined as the difference between revenues and expenses (plus or minus gains and losses). This is tautologically correct, but it is not particularly insightful. Attempts to dig deeper by exploring various definitions of *revenues* and *expenses* suffer from the same problem. An expense is typically defined as an *expired cost*, but the definition is silent on the basis for determining expiration. For example, consider the definition of *depreciation*, which has been described as the allocation of the original cost over the estimated useful life. Again this is tautologically correct, but it provides no insight into what criteria to use in selecting an allocation method from among a large number of possibilities.

Another approach is to ask, "What properties should the 'ideal' net income have?" Accounting alternatives would then be evaluated in terms of these "desirable" criteria. When a "desirable" properties approach is pursued, financial accounting theorists have usually adopted an *economic income* approach. Under this approach, accounting alternatives are evaluated in terms of their perceived proximity to this "ideal." It is assumed that economic income is a well-defined concept, and in most cases certainty is assumed or uncertainty is treated in a casual manner. In a multiperiod setting the discounted present value of future cash flows is usually adopted as the valuation model for the firm and its securities. *Economic income* is defined as the change in the present value of the future cash flows, after proper adjustments for deposits (for example, additional common stock issues) or withdrawals (for example, dividends).

As will be shown in Chapter 3, this concept is virtually unassailable under conditions of perfect and complete markets. For example, it not only reflects the effects of management's actions on current year's operations (for example, current cash flows), but also incorporates the future effects into this year's measure of net income. Hence, from a stewardship perspective, economic net income has appealing qualities.

This perspective can be traced to the early classics of Paton (1922), Canning (1929), and Alexander (1950). It has been applied to the comparison of specific accounting alternatives, such as depreciation methods, lease accounting, and the treatment of long-term receivables and payables. This approach also motivates proposals for market value or current cost approaches to financial reporting, which appear in Edwards and Bell (1961), Chambers (1966), and Sterling (1970).

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## 1-2 INFORMATIONAL PERSPECTIVE

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In the late 1960s the perspective shifted from economic income measurement to an “informational” approach. This is reflected in financial accounting research in information economics, security prices, and behavioral science. The emphasis is reflected in the FASB’s *Statement of Financial Accounting Concepts No. 1* (1978), which states:

Financial reporting should provide information that is useful to present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts. . . . Since investors’ and creditors’ cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise. (p. viii)

The notion that financial statement data ought to provide useful information on the assessment of future cash flows appears to be relatively innocuous. However, if taken seriously, the informational perspective has several dramatic implications for financial statement preparation and interpretation.<sup>4</sup> Chapter 2 will explore the informational approach and its implications.

There are at least two reasons for this shift in emphasis. (1) The concept of economic income is not well-defined when there are imperfect or incomplete markets for the assets and claims related to the firm. For example, in the simple case of certainty, the value of the firm is described in terms of the present value of the future cash flows. The present value model effectively collapses the multiperiod cash flows into a single number called the *present value*. Perfect and complete markets are sufficient to permit the vector of cash flows to be adequately described by a single number. Without perfect and complete markets, the properties of such a collapsing operation are not clear. Given that many of the assets and claims reported on the financial statements are represented by imperfect or incomplete markets, the concept of economic income is not well-defined. Hence, the “ideal” that financial statement data are attempting to represent is not clear conceptually. (2) Moreover, even in situations in which the relevant markets for claims exist (for example, marketable equity securities) there seems to be an inability to reach a consensus of the “best” method of reporting. More is at stake in the setting of financial accounting standards than is evident when adopting an economic income approach. Various groups or constituencies, such as shareholders, creditors, financial analysts, regulators (for example, the FASB and the SEC), management, and auditors, are affected by the choice of the financial reporting requirements. Hence, they have interests in which requirement is chosen. These interests are not incorporated within the framework of an economic income approach. In any event, the economic income perspective does not lead to a consensus on what financial standards should be, and the reasons for the lack of consensus are obscured by this perspective.

<sup>4</sup>Armstrong (1977) reported substantial opposition to adopting an informational perspective. Stewardship was cited most often as the preferred alternative. However, according to the FASB (1976b), stewardship is subsumed under the informational perspective.

Financial reporting data play two distinct, but related, informational roles. One role is to facilitate decision makers, such as investors, in selecting the best action among the available alternatives, such as alternative investment portfolios. A second role is to facilitate contracting between parties, such as management and investors, by having the payment under the contract defined in part in terms of financial reporting data. Management incentive contracts defined in part in terms of the firm's accounting net income would be an example. Both roles aid in the understanding of why management and financial reporting regulators perceive the choice of accounting method to be a substantive issue. This perspective also helps us understand why the standard-setting is the result of a political process. Chapter 2 describes both roles in greater detail.

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### 1-3 ACCRUAL ACCOUNTING IN AN INFORMATIONAL SETTING

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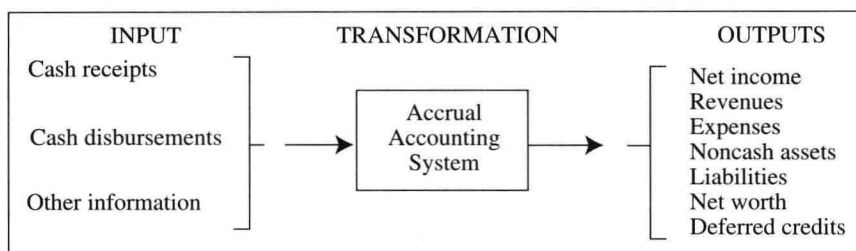
Although the informational perspective potentially represents a dramatic shift in the purpose of financial statements, the FASB concluded that accrual accounting with its attendant net income number is still superior to cash flow accounting with respect to the “new” purpose—information about future cash flows. According to the FASB (1978),

Information about enterprise earnings based on accrual accounting generally provides a better indication of enterprise's present and continuing ability to generate cash flows than information limited to the financial aspects of cash receipts and payments. (p. ix)

*The primary focus of financial reporting is information about earnings and its components.* (p. ix; emphasis added)

Notwithstanding the assurances of the FASB, there has been some questioning of the efficacy of the accrual system. One trend in security analysis is away from earnings-oriented valuation approaches to discounted cash flow approaches. Deficiencies in current financial reporting rules are given as a primary reason. Ijiri (1978) has expressed concern over the importance of accruals. He suggested that financial statements be based on a cash flow orientation, and he offered several reasons for this recommendation: (1) There is a direct logical link between past cash flows and future cash flows (in other words, they are of a similar nature or character). (2) Cash flows offer a more primitive system. By the principle of Occam's razor (a principle approximately 700 years old), the simpler method should be used until the more complex one has proven that it adds something. (3) Cash flow is less misleading in the sense that it does not have the same connotations that earnings do, which are often viewed as an indicator of economic income.

To challenge the accrual process strikes at the heart of financial accounting and financial statements as they are currently structured. It is not surprising that the FASB chose to reaffirm the importance of accrual accounting. Accrual accounting represents one way of transforming or aggregating cash flows, as illustrated in the



**FIGURE 1-1 The Accrual Process**

Figure 1-1. Accrual accounting reflects information in addition to cash receipts and disbursements. For example, information on the aging of receivables may be reflected in the allowance for estimated uncollectible accounts. Inventory, under a lower of cost or market rule, may reflect information on salability of inventory. More generally, the accruals reflect management's expectations about future cash flows and are based on an information system potentially more comprehensive than past and current cash flows. Accruals can be said to involve some implicit or explicit prediction of the future, and accrual accounting can convey information not contained in cash receipts and disbursements. As suggested by the FASB, accrual accounting may transform cash flows to provide a better indicator of future cash flows and dividend-paying ability than current cash flows do.

However, the efficacy of accrual accounting is an open issue. Why not merely place the underlying source data in the public domain? One issue is the comparative costs of processing the data. To the extent that data items would be processed (for example, aggregated) by investors in a relatively uniform manner, it may be cost-effective to have the corporation perform the process once instead of having the process performed several times over by analysts and investors. Of course, there may be no consensus on the method of aggregation, and generally there is a loss of information when aggregating. Hence, when presented with aggregated data, users may incur costs in an attempt to restore the lost information. So the cost of processing may not be related to the level of aggregation in any simple fashion. Moreover, in addition to the cost issues, there are other consequences of nondisclosure due to aggregated data. Hence, the appropriate level of aggregation is not a trivial issue, and income determination can be viewed as one special case. In this context, accrual accounting can be viewed as one potentially cost-effective compromise between merely reporting cash flows and a more ambitious system of fuller disclosure. These issues are discussed more fully in later chapters.

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## 1-4 THE FINANCIAL REPORTING ENVIRONMENT

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The shift toward an informational perspective can be better understood in light of the current financial reporting environment. This environment consists of various groups or constituencies who are affected by and have a stake in the financial re-

porting requirements of the FASB and the SEC. These groups include investors, information intermediaries, regulators, management, and auditors, among others.<sup>5</sup>

The investment process, a central feature of the financial reporting environment, involves the giving up of current consumption for securities, which are claims to future, uncertain cash flows. The claims to uncertain future cash flows are of value because they represent command over future consumption. Hence, investment is the giving up of current consumption for future, uncertain consumption. The investor must decide how to allocate wealth between current consumption and investment and how to allocate funds set aside for investment among the various securities available. The investor naturally has a demand for information that will aid in assessing the future cash flows associated with the securities and the firms that offer those securities.

However, the investor is not acting in isolation but within a larger investment environment. This environment consists of several characteristics: (1) Investors, some perhaps with limited financial and accounting training, have the opportunity to avail themselves of the services of financial intermediaries, such as investment companies, to whom they can defer a portion of the investment process. (2) Investors, some perhaps with limited access to and ability to interpret financial information, have the opportunity to avail themselves of the services of information intermediaries, such as analysts, to whom they can defer a portion or all of the information gathering and processing function. (3) Investors have the opportunity to invest in a number of securities and to diversify out of some of the risks associated with a single security. (4) Information intermediaries compete with one another in gathering and interpreting financial information. (5) Managements, competing with one another for the investors' funds, have incentives to provide financial information to the investment community. (6) Investors and intermediaries have information available that is more comprehensive and perhaps more timely than the annual report to shareholders or the SEC filings. (7) Security price research suggests that security prices reflect a rich, comprehensive information system. (8) The flow of financial information to the investment community is regulated by a dual regulatory structure that consists of the private-sector FASB and the public-sector SEC.

<sup>5</sup>Unless otherwise indicated, the term *investors* will refer to common shareholders. This usage is consistent with that of the FASB quotation cited earlier. The primary user orientation of both the FASB and the SEC is the common stock investor. This orientation is natural given the intent of the Securities Acts of 1933 and 1934. Other groups include creditors and employees. Neither will be given explicit treatment here. Creditors are a form of investor (supplier of capital). Although their interests may not be the same as those of the stockholders, many of the general statements made with respect to investors also apply or could be easily extended to creditors. As a result, creditors will not be treated here as a separate constituency. The reason is parsimony of exposition and does not imply that creditors are unimportant. In the United States employees have played a relatively minor role in the financial reporting environment. However, in many countries of Western Europe employees play a more active role, and they may eventually do so in the United States as well.

## Investors

Investors are a heterogeneous group in many ways. For example, they may differ with respect to tastes or preferences, wealth, beliefs, access to financial information, and skill in interpreting financial information. These factors can affect their demand for financial information. In general, the demand for information will be a function of the investor's wealth, tastes (for example, attitudes toward risk), and beliefs about the future. Because these attributes differ across investors, their demand for financial information can also naturally differ. In addition, investors may also differ in their access and ability to interpret financial information. As a result, the information demands of professional users, such as the financial and information intermediaries, may differ from that of the nonprofessional users, such as individual or noninstitutional investors.

Nonprofessional investors can also differ in many respects. Such investors may not operate in an unaided fashion and have a variety of investment strategies available. These options illustrate some reasons for heterogeneity among investors with respect to demand for financial information: (1) direct management of portfolio versus deferral of investment function to an intermediary, (2) use versus nonuse of information intermediaries, (3) diversified versus undiversified portfolio policies, and (4) active versus passive portfolio management.

If an individual investor defers a portion of the investment process to a financial intermediary, that individual may have a reduced direct demand for financial information.<sup>6</sup> To the extent that the individual relies on the analysis and recommendations of an information intermediary, the direct demand for financial information may also be reduced.<sup>7</sup> The individual, perhaps because of limited access and ability to interpret financial information, may choose to defer such functions to an intermediary. The individual is substituting the analysis and recommendations (in other words, the information) of the intermediary for the financial information. In this sense, they constitute competing sources of information. In both cases (deferral to a financial intermediary and deferral to an information intermediary), there may be an indirect demand for financial information by the individual investors.

Apart from options involving the extent to which the individual investor can defer to intermediaries, investors may also differ with respect to portfolio strategies. One dimension of this investment choice is the extent to which the investor chooses to be diversified. For example, mean-variance portfolio theory (Sharpe 1995) indicates that individual securities are relevant to the investor only in so far as they af-

<sup>6</sup>The term *financial intermediary* as used here includes those involved in investing the funds of others. Specifically, it includes mutual funds, closed end investment companies, investment trusts, and pension funds, among others.

<sup>7</sup>The term *information intermediary* as used here includes those involved in the gathering, processing, analyzing, and interpreting of financial information. It includes financial analysts, bond rating agencies, stock rating agencies, investment advisory services, and brokerage firms, among others.

fect the risk (variance of return) and expected return associated with the portfolios. Under this view, the objects of interest to the investor are the risk and expected return of the entire portfolio. Individual securities are means by which different portfolios can be constructed. From this perspective, interactions or correlations among the returns of securities are of interest, as well as the expected return and variability of return of the individual security. In fact, for well-diversified portfolios, some aspects of individual security return behavior may be relatively unimportant because they can be diversified away, such as the so-called unsystematic risk. Portfolio theory stresses the importance of diversification, which can reduce much of the uncertainty or risk associated with holding a single security. For example, a single security may have considerable uncertainty as to the return, yet through diversification much of this risk (unsystematic or diversifiable risk) can be eliminated at the portfolio level.

As a result, the demand for financial information may be a function of the extent to which the investor chooses to diversify. The investor is concerned with financial information only in so far as it is useful in assessing the attributes of the portfolio return. For the well-diversified investor, factors such as unsystematic risk may be relatively unimportant, and financial information that helps assess such risk may not be of value. However, for the less diversified investor, such information may be perceived to be extremely valuable.

In a similar vein, the demand for financial information can be influenced by the extent to which the investor adopts an "active" versus a "passive" trading strategy. Under a passive trading strategy, the investor essentially buys and holds a security and anticipates little trading until liquidation for consumption purposes. In the limit, the investor would simply purchase a well-diversified cross section of securities (for example, an "index" fund) and the direct demand for firm-specific financial information would be essentially nonexistent. By contrast, an "active" trader has a speculative demand for information. In other words, an active policy involves continually seeking information that will permit the detection of mispriced securities and continually trading on such information. By definition, the turnover of the active portfolio will be greater than that implied by a passive policy. In many cases, an active trading policy is attempting to take advantage of perceived short-term aberrations in security prices and expects to open and close the speculative position in a relatively short time period. Here, information that helps predict short-run movements in security prices is of interest to the active trader, but it would not be of interest to the investor who follows a passive policy and tends to adopt a longer-term perspective.

These classifications by no means exhaust the possibilities and they are not mutually exclusive. They do, however, illustrate a fundamental point. Investors are heterogeneous, and their demand for financial information can be heterogeneous. Moreover, they operate in an environment in which they can rely on financial and information intermediaries and in which they can adopt portfolio strategies that can substantially alter their direct demand for financial information.



## Information Intermediaries

The information intermediaries can be viewed as an industry whose factors of production include financial information and other types of data and whose product is analysis and interpretation. The output of the information intermediaries is also a form of information. The intermediaries take primitive information and transform it into another type of information, which reflects their ability to understand, synthesize, and interpret the raw data. As indicated earlier, the nonprofessional user may have less direct demand for financial information if that user relies on the information provided by an intermediary.

More specifically, information intermediaries can be viewed as performing three information-related activities: (1) the search for information that is not publicly available (hereafter called *private information search*), (2) the analysis, processing, and interpretation of information for prediction (hereafter called *prospective analysis*), and (3) the interpretation of events after the fact (hereafter called *retrospective analysis*).

As a result, the relationship between financial reporting and the information intermediary is not simple. At one level, public financial reporting provides one source of input factors for the intermediaries. However, if part of the function of the intermediary is to obtain more comprehensive and more timely information, financial reporting can be a competing source of information to that provided by the information intermediary. Moreover, information intermediaries compete with one another in the gathering and interpretation of financial information.

Information intermediaries engage in private information search. This private-sector information system is large and active.<sup>8</sup> The competition among analysts for disclosures and for the interpretation of disclosures may result in security prices that reflect a broad information system. Statements of legislative intent at the time of the enactment of the Securities Acts indicate that at least some were relying on the competition within the professional investment community to interpret the SEC filings and to effect an “efficiently” determined market price.<sup>9</sup> Chapter 6 will discuss further the relationship between security prices and financial information.

The role of the information and financial intermediaries in the financial reporting environment has been receiving increasing recognition by the financial reporting regulators. The recognition of the professional user as a prime target for the financial reporting system is reflected in the following ways:

1. Information intermediaries, such as analysts, are viewed as major representatives of investor demand for additional financial reporting. As a result, the FASB and the SEC look to this community as a source of ideas for further disclosures. As long as the financial reporting policy makers rely on information intermediaries,

<sup>8</sup>The role of analysts as information intermediaries is discussed in Schipper (1991).

<sup>9</sup>Consider the following statement by Justice William O. Douglas (1933), who at the time was teaching at Yale: “Even though an investor has neither the time, money, or intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price.”



their preferences will be an important barometer of future financial disclosure requirements. Analysts' interest in segment or divisionalized reporting and in management forecasts are prominent examples.<sup>10</sup>

2. The financial reporting requirements assume that the user has a greater sophistication and technical skill to interpret the data reported than has previously been assumed. The FASB's standards on foreign currency translation, pensions, other post-employment benefits, and stock options as compensation are prominent examples of financial reporting requirements that require a considerable amount of expertise in interpretation.
3. There is greater emphasis on the reporting of so-called soft data, such as future-oriented disclosures and current cost data.
4. There is greater emphasis on disclosure and less emphasis on a single earnings number. Disclosures are used to report financial aspects of certain events without an attempt to prescribe exactly how those disclosures are to be used to arrive at "the" net income or earnings for the firm. This shift away from a single "best" measure of earnings affords users a greater opportunity to structure the analysis of financial disclosures in a manner they perceive is appropriate. This is particularly important to the extent that users are heterogeneous in their demand for and analysis of financial information.

## Financial Reporting Regulators

A prominent feature of the financial reporting environment is the regulation of the flow of financial information to investors. The primary regulators are the FASB and the SEC, although Congress and the independent regulatory agencies can also influence financial reporting requirements.

The SEC and the FASB share a concern over the effect of the financial reporting on investors (FASB 1976b, Chapter 2, and SEC 1977, Introduction). The investor orientation is natural given the intent of the Securities Acts of 1933 and 1934. This orientation appears to be partially motivated by a concern over the welfare of investors, the "fairness" of the markets in which they buy and sell securities, and the prevention of perceived adversities and inequities that may befall investors due to informational deficiencies, such as a failure to disclose material financial information. However, the policy makers also appear to be concerned with the effects of financial reporting on resource allocation and capital formation.

A distinctive feature of the regulatory system is its dual structure. The relationship between the FASB and SEC has not been clearly defined, although a similar perspective on the purposes of financial reporting has been suggested for both. The SEC Advisory Committee on Corporate Disclosure (SEC 1977) suggested a purpose of corporate disclosure similar to the FASB's statement of purpose cited earlier. The Advisory Committee states that the SEC's objective in corporate disclosure is

<sup>10</sup>The financial analyst community has made several suggestions for increased financing reporting (see AIMR 1993).