ACCOUNTING SHOULD NOT REWARD IGNORANCE: THE FORGOTTEN UNSKILLED INVESTOR (OR WARNING: MISINTERPRETING FINANCIAL STATEMENTS MAY BE DANGEROUS TO YOUR WEALTH)

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"Accounting should not reward ignorance" was the value judgment offered by a leading academic during a recent discussion on the role of the F.A.S.B.* This point of view has appeared more and more frequently in the current literature (cited below) although it is often not clear that a value judgment is being presented. It is a position commonly taken in rebuttals of objections to implications for accounting of security price research. A recent release by the S.E.C. (referenced below) suggests that it may subscribe to the thesis. What is, or should be, the position of the F.A.S.B.? This paper outlines the importance of this issue to the formation of financial accounting standards. In part it involves a re-evaluation of the implications of research into the relationship between financial statement data and security prices.

It will be argued that a number of implications of security price research that have been stated are actually ambiguous unless, and until, one or both of the following issues are resolved: (1) what are the effects of certain financial accounting reporting practices on individuals, as distinguished from the effect on the securities market as a whole, (2) should society expend resources to protect the "unskilled" (in terms of sophistication in financial accounting) from their own actions. The first issue is an empirical one on which there is insufficient evidence. The second issue is a value judgment, the importance of which has not been sufficiently recognized.

The sufficiency of available evidence

Much of recent empirical research in accounting has been concerned with the relationship between security prices and financial statement data and the implications of such findings. Beaver (1973) discusses such research and implications and concludes (p. 52) that:

> Many reporting issues are trivial and do not warrant an expenditure of FASB resources. The properties of such issues are twofold: (1) There is essentially no difference in cost to the firm of reporting either method. (2) There is essentially no cost to statement users in adjusting from one method to the other. In such cases, there is a simple solution. Report one method, with sufficient footnote disclosure to permit adjustment to the other, and let the market interpret implications of the data for security prices.

Such a view is based on a belief in the efficiency of the market in assessing the implications of publicly available information. It does not adequately consider the efficiency of proper subsets of (i.e., individuals in) the market in evaluating the implications of available information.

The individual's task can be viewed as one of selecting a diversified portfolio of securities which is consistent with his personal tradeoff between risk and return. The actual behaviour of investors provides an indication of how well they fulfill this task. A recent evaluation of such behaviour (McDonald, 1974) suggested that the typical individual investor was not well-diversified and naively optimistic. Such performance may be due to a lack of understanding concerning the appropriate objectives to be pursued. For example, investors may attempt to "beat the market" using publicly available information which by definition is not possible in a semi-strong efficient market. Alternatively, poor performance may be the result of errors made in attempting to achieve appropriate objectives. Fama (1965, p. 40) characterizes the investor's task in an efficient market as follows:

*U.S. Financial Accounting Standards Board — the discussion took place at the 1974 Annual meeting of the American Accounting Association in New Orleans.

> If actual prices at any point in time are good estimates of intrinsic values, he (the investor) need not be concerned with whether individual securities are over or under-priced. If he decides that his portfolio requires an additional security from a given risk class, he can choose that security randomly from within the class. On the average any security so chosen will have about the same effect on the expected return and riskiness of his portfolio.

However, before the investor can decide that he requires an additional security from a given risk class, he must be able to (1) identify the risks of the available securities and (2) compare expected return with risk. Thus he requires information on these two variables across securities. In the analysis he may make errors, not only of the expectation variety, but also in interpreting publicly available information.

The inability of some investors to interpret financial statement data as well as other investors can be viewed as a situation in which these other investors trade on information which is not publicly available to the former group of "unskilled" investors. How extreme must this situation become before it can be concluded that financial statement information is not publicly available in general and thus constitutes inside information which can possibly be used to earn abnormal returns in a semi-strong efficient market? One large public-accounting firm has suggested that this position may have already been attained in that it has argued (Arthur Anderson & Co., 1972, pp. 85-86, emphasis added):

> In recent years more and more detailed disclosures have been emphasized in financial statements and footnotes. This started with the correspondence between the AICPA and the New York Stock Exchange in 1932, which recommended disclosure of accounting methods — as though the investor was somehow to use this information and perform his own accounting. Extensive disclosures in compliance with the requirements of the Securities and Exchange Commission in the United States, compounded by disclosure constantly being added under the requirements of professional pronouncements, must be thoroughly confusing to most investors. *More seriously, such disclosures may be tantamount to providing insider information since they are likely to be understood by only a sophisticated few, giving them additional advantages over other investors — precisely what financial statements should not do.*

Interpretations of results of recent research into the association between financial statement information and security prices have been based on the premise that financial statement information is "publicly available". It has been suggested above that this may not be the actual situation. The issue revolves around the meaning of "publicly available", a critical term in the definition of market efficiency in the semi-strong form which in turn is the foundation of recent policy recommendations based on security price research. The ambiguity is present in one appealing *a priori* argument (Fama, 1965) for the existence of market efficiency. The argument involves the existence of a sufficient number of "sophisticated" investors (or rather sufficient in terms of resources) learning of any dependencies between available information and return (i.e. price change), trading on them and so eliminating them. Fama's argument continues (pp. 39-40):

> The above discussion implies, of course, that, if there are many astute traders in the market, on the average the full effects of new information on intrinsic values will be reflected nearly instantaneously in actual prices. In fact, however, because there is vagueness or uncertainty surrounding new information, "instantaneous adjustment" really has two implications. First, actual prices will initially overadjust to the new intrinsic values as often as they will underadjust. Second, the lag in the complete adjustment of actual prices to successive new intrinsic values will itself be an independent random variable, sometimes preceding the new information which is the basis of the change (i.e., when the information is anticipated by the market before it actually appears) and sometimes following. It is clear that in this case successive price changes in individual securities will be independent random variables. In a dynamic economy there will always be new information which causes intrinsic values to change over

> time. As a result, people who can consistently predict the appearance of *new* information *and* evaluate its effects on intrinsic values will usually make larger profits than can people who do not have this talent. The fact that the activities of these superior analysts help to make successive price changes independent does *not* imply that their expected profits cannot be greater than those of the investor who follows some naive buy-and-hold policy.

It must be emphasized, however, that the comparative advantage of the superior analyst over his less talented competitors lies in his ability to predict consistently the appearance of *new* information and evaluate its impact on intrinsic values. If there are enough superior analysts, their existence will be sufficient to insure that actual market prices are on the basis of all available information, best estimates of intrinsic values. In this way, of course, the superior analysts make intrinsic value analysis a useless tool for both the average analyst and the average investor.

In order for superior analysts to make above-normal gains, it would seem to be necessary for them to make consistently better evaluations of available information than are implicit in market prices. Yet, elsewhere, Fama (1970, p. 388) has argued this would deny market efficiency:

> . . . disagreement among investors about the implications of given information does not in itself imply market inefficiency unless there are investors who can consistently make better evaluations of available information than are implicit in market prices.

But then superior analysts were argued to earn their abnormal returns from generating *new* information so that possibly only the strong form of market efficiency is questioned here. However, if prediction of new information can be used to make above-average gains without contradicting the efficient-market hypothesis in its semi-strong form, at what point do transformations of publicly available information cease to be publicly available? That is, capital-market efficiency in its semi-strong form denies the possibility of using publicly available information to consistently make above-average gains, yet allows the use of publicly available information to predict "new" information which can be used to make above average gains — at what point does "use" become "prediction of new information"? One way out of the apparent contradiction is to argue that superior analysts are the medium by which the market is efficient in the semi-strong form, and that above-average returns are their reward for this function. Such an interpretation of stock market behaviour admits that not all information contained in financial statements may be "publicly available". Financial accounting policy decisions which rely on "disclosure" as a solution may possibly result in the provision of "inside" information. An alternate way of stating the problem is to suggest that some individuals may be "functionally fixated" so that additional disclosure which enables alternate measurements to be determined does not "neutralize" the choice of financial accounting method to be used in the statements. This possibility appears implied in the resistance of firms in financial industries (e.g., insurance companies) to incorporate unrealized gains and losses in the income statement even though this information can often be obtained by using notes to the financial statements which indicate market values of investments.

Present evidence is not a sufficient basis on which to evaluate such hypotheses. Indeed, the very definition of market efficiency, expressed in terms of market prices and thus independently of individual behaviour, does not concern itself with such issues. Should resources be expended to obtain such evidence? If the evidence is collected and suggests that financial accounting disclosures do not distribute information equally across readers should additional resources be expended on additional disclosure to rectify the situation? In part at least, the responses to these questions will depend upon how importantly the lack of skill in financial accounting of some users is viewed by policy makers. That is, a value judgment is required.

Equality before the F.A.S.B.

The Study Group on the Objectives of Financial Statements took the position (1973, p. 17) that "Financial statements are . . . especially important to those who have limited access to information and limited ability to interpret it." Where

resource allocation choices must be made it would be desirable to have available a social welfare function the maximization of which would serve as an objective in such choices. It has been demonstrated (Arrow, 1963) that there is no nondictatorial and, at the same time, "reasonable" way of combining the welfare (utility) functions of individuals to form a social or aggregate welfare function. In the absence of such a choice, criterion value judgments will need to be made by policy makers.

It is important for policy makers to distinguish value judgments from empirical findings when evaluating results of reported research. While the value judgments of others need to be identified and considered, the FASB will finally have to determine its own position. One point of view which has been expressed (Beaver, 1973, p. 53) states:

> . . . the FASB must not attempt to reduce the complex events of multi-million dollar corporations to the level of understanding of the naive, or, perhaps more appropriately labeled, ignorant investor.

This position apparently reflects a concern that society's resources not be used inadvisedly, in that elsewhere Beaver (1974, p. 569) has argued:

> To the extent society as a whole is capable of diversifying out of [diversifiable or] unsystematic risk, it is not going to compensate individual investors for unsystematic risk, regardless of how non-diversified an individual investor may choose to be. Incorporating unsystematic risk in information policy decisions may be tantamount to recommending that accounting expend society's real resources in attempting to reduce a factor (unsystematic risk) for which the securities market is not compensating the investor.

The dimensions of the problem may be considerable as McDonald (1974) has concluded that the typical investor may not be well-diversified, and the activity of individuals in the market has increased in recent history — it has doubled in terms of share volume and increased fifty percent in dollar volume between 1961 and 1971 (Murray, 1974, p.20). Parenthetically, it can be noted that in other aspects of human affairs society has expended its resources in protecting individuals from themselves.

A recent Securities Act Release by the S.E.C. appears to have assumed that all information contained in financial statements is "publicly available" to all and that disclosure prevents discrimination. Commissioner Sommer's (1974) analysis of this release and "differential disclosure" is very much to the point of the problems raised above.

It is submitted that if financial statements are not to be formulated at the level of understanding of the average unskilled investor then at least the unwary should be warned. It is suggested that some statement similar to the following would be appropriately displayed upon financial statements:

> Warning: Misinterpreting Financial Statements May Be Dangerous to Your Wealth.

Summary

It is possible that securities markets are efficient because of the actions of skilled investors taking advantage of arbitrage opportunities presented by the actions of unskilled investors. In addition, it is possible that unskilled investors in being unable to understand available information incur penalties in the form of one or more of the following: (1) excessive transactions costs, (2) holding portfolios inappropriate for given personal tradeoffs between risk and return, and (3) being forced to pay the skilled for the service of interpreting available information. Disclosure of new information in financial statements may improve the efficiency of the market "as a whole" but does not necessarily address the problems of the individual investor. How important these problems are to the F.A.S.B. is a value judgment it will need to make. In the very least it will need to decide how important it is to (1) provide empirical data to evaluate the extent of the problems which have been alluded to above, and (2) support research which attempts to model the process by which information is distributed among market participants. Some preliminary work in these areas is already available. For example, Rubinstein (1973) has considered a definition of market efficiency from the individual's point of view; Ng (1974) has considered the influence of "accuracy" of information on market allocations; Winsen (1973) has attempted

to use market data to evaluate individual behaviour and Winsen and Ng (1974) have attempted to evaluate the effect of changes in accounting methods on individuals in the market.

If financial statements are not to be presented at the level of understanding of the average unskilled investor, it has been suggested that at least the unwary should be warned.

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BOOK REVIEW

MANAGING FINANCIAL INSTITUTIONS

Financial Management of Financial Institutions, by George H. Hempel and Jess B. Yawitz, Prentice-Hall, Englewood Cliffs, New Jersey, 1977. Pp. 263. Flexible cover, $A12.25.

As the eleventh volume in its excellent Prentice-Hall Foundations of Finance Series, that publishing house recently issued a good cheap book entitled *Financial Management of Financial Institutions* written by George H. Hempel and Jess B. Yawitz. Books in this subject are scarce and most of the good ones available have come from U.S. authors and publishing houses. This one discusses modern financial management techniques for financial institutions, with special reference to the management of the financial resources, both assets and liabilities, of U.S. financial institutions.

It is organised into three basic sections. The first contains a concise discussion of the economic role of financial institutions and the necessity that they continue to fill that role. The second section is organised around the major types of financial institutions. In the third section, the authors argue that the environment in which financial institututions must operate is not static but dynamic, and they present some forecasts as to how that environment may change in the next few years.

Of the authors, George Hempel is Professor of Finance and Jess Yawitz is Associate Professor of Finance and Business Economics, both at Washington University. It's a very useful book.

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