Meeting the Information needs of users

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INTRODUCTION

The AICPA's Board of Directors formed the Special Committee on Financial Reporting in the Spring of 1991 to address increasing concerns about the relevance and usefulness of external reporting. Our specific charge is to recommend (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information.

Information is central to the operation of effective capital markets. Informed capital markets get capital to the right companies and price that capital at a cost appropriate to the risks involved. Conversely, uninformed markets struggle to distinguish between worthy companies and others, and have difficulty judging risk. Uninformed markets misallocate and misprice capital - to the detriment of almost everyone.

The Committee believes that external financial reporting has the unique role of reducing information risks and uncertainties that investors and creditors (the users of external reporting) must deal with by providing relevant and reliable information. Logically, external reporting will be valued in proportion to the contributions it makes - or fails to make - to users' decision-making.

Thus, the Committee is focusing on the information needs of users, and its recommendations to improve external reporting will be responsive to those needs. To that end, the Committee just finished an unprecedented, comprehensive research effort designed to determine the specific information needs of today's users.

The continued relevance of external reporting is at risk. The basic problem is that the world is rapidly changing and external reporting is not changing to keep pace. Here are three examples.

For one, traditional external reporting was not designed to predict the future. Yet, investors and creditors need information that helps them do just that. External reporting focuses on the past. Yet, the pace of change is accelerating and the past is less likely to
be a good predictor of the future. Further, because of dramatic leaps in technology, there are many emerging industries with limited history. For them reporting only on the past is not helpful. Reporting what happened is often important, but it cannot be the preoccupation of external reporting. External reporting needs to be more forward looking and present a more balanced package of information about the future as well as the past.

For another, there is a revolution in how companies are organized and managed. To be more nimble, command and control styles of management are being replaced by a more participative, networked style of organization. Further, companies that used to focus mostly on financial performance measures are now focusing on an ever widening array of nonfinancial measures of performance that assess the cost, quality, time, and innovation of their products and services. While the revolution continues, external reporting continues to focus on financial statements. Financial statements remain an important part of the users’ analysis. But they are only part. Users are interested in how management is running and measuring the business. External reporting needs to keep pace with changes in management. It must report both the financial and nonfinancial measures used to manage the business.

A third example involves the reporting entity. Traditional reporting focuses on the consolidated reporting entity - the company and its subsidiaries reporting as a single unit. Yet, many or even most companies have divided their activities into business segments to effectively manage those activities. It is the segments that render products and services and create value. Focusing only on the consolidated total often fails to provide a clear picture of the very different business activities within the company. To make accurate judgments about a company, users need to assess both the activities within the business segments as well as the entire company. Similarly, external reporting needs to balance reporting about the entire company with increased reporting about the individual segments of the business.

Management itself is changing the boundaries of the reporting entity. In response to increased competition, the pace of change, and different management philosophy, companies are changing their relationships with other entities with which they do business. Companies are entering into long-term relationships with suppliers and customers that look more like partnerships than the arms-length and sometimes hostile relationships of the past. Companies are also entering into more ventures with companies in related industries, and even competitors, as a means to reduce costs, increase value, and take advantage of new technology while limiting the risk of failure. At a minimum, users need to understand the purpose and impact of those new relationships. In a world of tightly woven business relationships, external reporting can no longer focus solely on the company.

These are only a few examples of how change is threatening the continued relevance of external reporting and thus informed capital markets. There are others.
RESULTS OF USERS' NEEDS STUDY

In order to respond to our charge, the Special Committee has focused on determining users' needs for information necessary to make investment and credit decisions. The work has involved learning about these information needs directly from users — rather than inferring user needs based on our expertise as accountants and auditors. In this respect, I believe the work of the Committee is unique. Over the last eighteen months, we have carried out a number of activities leading to our analysis of users' needs which included:

- Study and analysis of documents either written by investors and creditors or based on research directly with investors and creditors about their needs for information.

- Formal meetings with investor and creditor discussion groups.

- Meeting with (a) the Financial Accounting Policies Committee of the Association of Investment Management and Research and (b) the Accounting Policies Committee of the Robert Morris Associates.

- Informal meetings with other individual investors and creditors.

- Research sponsored by the Special Committee about the types of information included in analysts' formal reports about companies.

Our research has confirmed that traditional audited financial statements failed to meet certain critical information needs of investors and creditors. These users are deeply concerned about the relevance, reliability, comparability, and neutrality of the financial and other information that they use in their analyses and investment and credit decisions.

Credibility of reporting is also viewed as an area of significant concern. Users believe that many companies' managements are not always forthright in reporting problems and poor company performance. They do not believe that management intentionally attempts to mislead readers, but they suspect that management's striving to report its situation in the best possible light results in an apparent loss of neutrality that reduces the completeness and overall usefulness of the information.

Now let's discuss some specific areas where users believe additional information is needed.
Disaggregated Disclosures

The Special Committee's research revealed that users place a high value on segment reporting but believe that existing accounting guidance relating to disaggregated disclosures does not provide adequate information to help them predict an entity's future earnings and cash flows. At a minimum, users need disaggregated information on the same basis that management follows in managing its business and on a geographic basis. Many users believe that this disaggregated information should be presented quarterly rather than on an annual basis as is presently done.

Core Earnings

Another major issue raised by users is the need for a workable concept of presenting core earnings. Users need to estimate the amounts, timing and uncertainties of the future cash flows of an entity. They need information on current and past events, classified into relevant categories, to help them make those estimates. Users indicate that core earnings are key to their analysis. Core earnings is not defined in generally accepted accounting principles (and users don't want accountants to do so) but can be thought of as the portion of earnings for the reporting period that provides users with the best information with which to predict future cash flows from operations.

If a separate caption titled core earnings were displayed on the income statement, users would want the statements to include sufficient information about nonrecurring, unusual and infrequent items as well. A concept of comprehensive income might be useful here.

Other Financial Statement Areas

A number of other specific areas in financial reporting were identified by users as needing attention. For example.

- Disclosures should be made about the estimates and assumptions used to determine material asset and liability amounts unless the disclosures would result in a competitive disadvantage.

- More detailed information should be provided about unconsolidated entities in general and about "significant" investees in particular.

- More information, both qualitative and quantitative, should be disclosed about the risks associated with financial instruments and off-balance sheet financing arrangements.
Opportunities and Risks

Financial statement users identified the need for more information about operating opportunities and risks — those known circumstances in which the reporting entity is involved that have not resulted in recorded assets or liabilities at the reporting date but that may cause the entity to have increases or decreases in cash flows in the future. The SEC MD&A requirements, which focus on events and uncertainties that would cause the reported information to be an inadequate indicator of true operating results, represent a good framework for disclosures about operating risks, although users believe that disclosures now made pursuant to the MD&A requirements are not as good as they should be.

Forward-Looking Information

In the context of the Special Committee's work, forward-looking information includes both financial and nonfinancial information. Users consider forward-looking information an important part of their analysis and would welcome additional forward-looking information in external reports, including qualitative as well as quantitative information.

However, users do not seek management's projections or forecasts because of a belief that they are fundamentally unreliable, inherently imprecise and overly optimistic, preferring instead to make their own projections and forecasts based on better information provided in financial reporting and their own judgments.

Nonfinancial Business Information

Users indicated an extensive need for nonfinancial business information. For example, users view as very important a description of the business, the structure of the industry and relationships among major shareholders, directors, management and the company, preferably disaggregated. Additionally, they desire nonfinancial information about market acceptance, costs, productivity, innovation and the amount/quality of resources, with explanations of relationships and changes among the statistics between periods.

Auditor Involvement

Users also have a strong interest in the role of the auditor in financial reporting. Adding reliability to reported information is essential, particularly since many users are somewhat skeptical about the motives of management. Maintaining the independence of the auditor is thus essential to the process and users are concerned about the various pressures placed on auditors in this regard.

While users rely on the standard audit report as a benchmark, they believe auditors should be more flexible and provide additional qualitative commentary in their reports. For example, users would find comments helpful in the following areas:
• audit scope and findings

• the entity's accounting and reporting practices in relation to other alternative accounting methods

• reasonableness of significant assumptions and estimates used by management in the preparation of its financial statements

• risks associated with realizing recorded assets

• adequacy of the entity's internal control systems

• compliance with laws and regulations

FUTURE WORK OF THE SPECIAL COMMITTEE

Over the past two years the Special Committee has been studying ways to address what we believed we might hear from users and now the members of the Special Committee are working on developing possible responses to the information needs of users.

We have not arrived at any final recommendations at this point. Some of the information needs may not be able to be met in the current litigious environment; for others, competitive considerations will be a constraint. Other costs of providing information need to be considered. We have established the following rules to guide our decisions in these areas:

1. Management should not report information that would harm their company's competitive position.

2. Management should not report information about other companies because, generally, management is not the best source of that information. Rather, the disclosures should emphasize management's expectations about how the environment may impact their company.

3. Management should not be required to provide projected nonfinancial or financial measures. Rather, management should provide information that helps investors and creditors project those measures for themselves.

4. Management need only report what nonfinancial information it knows. That is, management should be under no obligation to search for nonfinancial information that it does not have, or need, to manage the business.

5. There must be legal safeharbors for management's disclosures of forward-looking information. It is unreasonable to expect management to make candid disclosures of forward-looking information with a high risk of subsequent litigation with the benefit of hindsight.
Once we have arrived at a financial reporting model that is as responsive as possible to the information needs of users, we plan to develop a prototype to illustrate the application of our ideas. We have already arranged for the business community to participate with us in developing this prototype. We also intend to discuss our ideas with a wide-range of constituents, including others in the business community, standard setters and regulators.

It is only then that we will make our recommendations. Even at that point we plan one more important step before issuing our recommendations in final form. The Special Committee expects to conduct a broad-based survey of users — investors and creditors and their advisors — to see if they concur that our recommendations are responsive to their information needs.

The Special Committee plans to accomplish all this and issue its report in late May 1994.

CONCLUSION

The Special Committee has made a tremendous effort, in my view, in its work to date and I am most grateful to the members and staff for their work and for their commitment to seeing this project through to completion. Our work on learning directly from users — not inferring their needs from other sources — is in and of itself an important and unique undertaking.

One of the major contributions of the Special Committee will be developing a better understanding of the information needs of users.

We have learned that the very definition of financial reporting must change. We must change from measuring assets and liabilities and reporting on transactions alone, to also providing more forward looking information — information for decision making. The Special Committee’s recommendations will be responsive to this needed shift so that reporting will be relevant to the users of information.