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Database of Materials on Users' Needs for Information

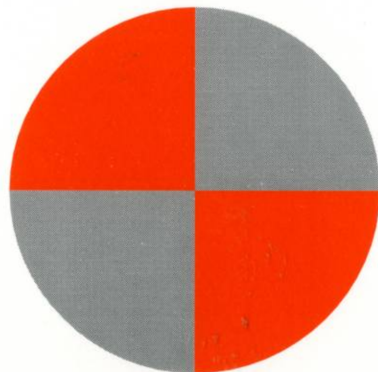
Special Committee on Financial Reporting

AICPA

VOLUME 1

Database of Materials on Users' Needs for Information

VOLUME 1



SPECIAL COMMITTEE ON FINANCIAL REPORTING
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Database of Materials on Users' Needs for Information

From a Study Conducted by the
SPECIAL COMMITTEE ON FINANCIAL REPORTING

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Notice to Readers

This database consists of documents prepared for and by the AICPA Special Committee on Financial Reporting on the information needs of users of business reports. The Committee has set forth its conclusions in a report issued September 1994, entitled *Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors.*

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Acknowledgments

The Special Committee is grateful for permission received from the authors to quote in the database from the following documents:

- SRI International, *Investor Information Needs and the Annual Report*, Financial Executives Research Foundation, 1987

- An unpublished paper prepared by the Accounting Policy Committee of Robert Morris Associates, *Summary of Important Positions Related to Accounting Principles and Auditing Standards*, © June 1990

- A letter from the Accounting Policies Committee of the Robert Morris Associates to Larry Grinstead © and dated September 16, 1992

- Permission to include portions of transcripts taken from interviews performed by the FASB Oversight Committee of the Financial Accounting Foundation was obtained from the Financial Accounting Foundation, © Financial Accounting Foundation.

- *Report of Association for Investment Management and Research, Corporate Information Committee Including Evaluation of Corporate Financial Reporting in Selected Industries for the year 1989-90*, © AIMR, 1990

- *Report of Association for Investment Management and Research, Corporate Information Committee Including Evaluation of Corporate Financial Reporting in Selected Industries for the year 1990-91*, © AIMR, 1991

- *Report of Association for Investment Management and Research, Corporate Information Committee Including Evaluation of Corporate Financial Reporting in Selected Industries for the years 1991-92*, © AIMR, 1992

- Unpublished paper prepared and © by the Association for Investment Management and Research, *Comments of Association for Investment Management and Research on Matters Addressed in Interview Guide of Oversight Committee, Financial Accounting Foundation*, April 3, 1991

- *The Financial Services Industry - Banks, Thrifts, Insurance Companies, and Securities Firms*, © AIMR, September 1992

- AIMR Position Paper, *Financial Reporting in the 1990's and Beyond*, © AIMR, July 1992

- KPMG Peat Marwick, *Estimating Fair Values for Financial Instruments: Disclosure and Beyond, a Study Prepared for the Association of Reserve City Bankers* (Washington D.C.: © KPMG Peat Marwick, 1992)

- Hill and Knowlton, Inc., *The Annual Report: A Question of Credibility - A Survey of Individual and Professional Investors*, © Hill and Knowlton, Inc., October 1984

- Towers Perrin, *FAS 196 and the Equity Markets: "Big Bang" - or Nonevent,* © Towers Perrin, October 1992

- *S & P's Corporate Finance Criteria,* © Standard and Poor's Corporation, Spring, 1992

- Unpublished paper © by Jean-Louis Betriou, Gèrard Ewenczyk, Jacques Meriaux, and Kaspar Muller, *Financial Analysts' Requirements in the Field of Accounting Data*

- Louis Harris, *A Study of the Attitudes Toward an Assessment of the Financial Accounting Standards Board,* © Louis Harris and Associates, 1985

AICPA Special Committee on Financial Reporting
Database of Materials on Users' Needs for Information
Introduction and Overview

The AICPA formed the Special Committee on Financial Reporting in 1991 to address concerns about the relevance and usefulness of business reporting. The Committee's charge was to recommend (1) the nature 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. The Committee completed its work in September, 1994.

Successful businesses align the features of their products and services with the needs of their customers. So too should the providers of business reporting align its features with the information needs of those who use it (primarily investors and creditors, including potential investors and creditors, and their advisors who use business reporting as a basis for their capital allocation decisions). Thus, the Committee focused on the information needs of users to help identify and evaluate ideas for improvement in business reporting.

The Committee studied the information needs of users and identified the types of information that users believe is most useful in predicting earnings or cash flows to value equity securities and to assess the prospect of repayment of debt securities or loans.

This database includes material from that study, which the Committee is making available to assist others in their research of the information needs of investors and creditors. It also includes the Committee's bibliography.

The database is divided into seven sections. Those sections are listed and described below.

I. The Committee's analysis of information needs of investors and creditors (112 pages)

This document summarizes the Committee's analysis of users' needs for information based on the information included in Section II of the database. The introductory material on pages 1 through 18 discusses the objectives, scope, basis for analysis, guiding principles, and organization of the analysis.

II. Material extracted from documents authored by users or based on research directly with users about their needs for information (about 1,200 pages)

The objective of the material is to organize what investors and creditors have indicated about their needs for information in a manner that best facilitates analysis. Thus, the materials are organized into categories and subcategories, as listed in the introduction to the materials.

The materials are extracted from direct documents, which are authored by users, or based on research directly with users. The materials include extracts from the direct documents listed at the front of the database.

In addition to extracts from previously published documents, the materials include extracts from new research sponsored by the Committee. New research resulted from the Committee's formal discussions with investors and creditors. The materials include the transcripts from those discussions, divided topic by topic. The second type of new research infers users' information needs based on the contents of analysts' reports. Extracts from that research is also distributed across various topics within the materials. Further, the study of analysts reports is included in section III of this database.

The introductory material (pages 1 through 9) discusses the objective, organization, contents, and format of the materials.

III. Content analysis of sell side financial analysts reports (48 pages)

This research infers users' information needs based on the contents of sell side analysts reports. Excerpts from this research are also included in section II of the database.

IV. Content analysis of information voluntarily supplied by companies to users (35 pages)

The Committee also sponsored this research, which was not completed in time to be included in Section II. The research is based on documents that certain public companies who agreed to participate in the study provided to users.

V. Survey of investors and creditors (61 pages)

The Committee sponsored the survey to confirm or refute with a large number of users its conclusions about users' needs as discussed in its analysis (section I of the database).

The survey is in three parts. The first is the Committee's analysis of the survey, which compares and contrasts the results of the survey with the Committee's conclusions in its earlier analysis. The second is the results of the survey, with commentary by Louis Harris, who conducted the survey. The third is the survey instrument.

VI. Report of the Committee's Breakthrough Task Force (21 pages)

The Committee sponsored a task force of experts in various disciplines to help the Committee develop a longer term perspective. The Task Force considered the

directions in which business information is likely to evolve as a result of changing social, political, economic, technological, regulatory and other forces. Section VI includes the Task Force's report.

VII Bibliography of source documents referred to by the Committee (10 pages)

The bibliography lists many of the published documents that the Committee considered in developing recommendations, including documents about users' needs for information as well as other matters.

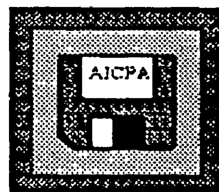
I The Committee's Analysis of Information Needs of Investors and Creditors

I The Committee's Analysis of Information Needs of Investors and Creditors

The AICPA Special Committee

on Financial Reporting

Users' Needs Subcommittee



Analysis of the Information Needs of Investors and Creditors

as of June 22, 1993

AICPA Special Committee on Financial Reporting
Users' Needs Subcommittee
Analysis of the Information Needs of Investors and Creditors
Introduction

The following materials are prepared by the Users' Needs Subcommittee (the Subcommittee) of the AICPA Special Committee on Financial Reporting (the Committee). The Committee's mission is to recommend improvements in external reporting. To carry out part of its work, the Committee formed the Subcommittee specifically to study the information needs of investors and creditors. Consistent with its charge, the following materials document the Subcommittee's analysis of those information needs. The Subcommittee's findings will provide a base on which the Committee may develop recommendations to improve external reporting and will help insure that the Committee's recommendations are responsive to the information needs of investors and creditors.

This introduction discusses the objectives, scope, basis for analysis, guiding principles, and organization of the Subcommittee's analysis.

Objectives

The objectives of the analysis are to (1) identify, describe, and support views about the information needs of investors and creditors that can be reasonably inferred from the Subcommittee's database of materials on users' needs for information and (2) present those views in a manner useful to the Committee in developing recommendations to improve external reporting.

Scope of the Subcommittee's Study About Users' Needs for Information

The Subcommittee undertook its study of users' needs for information solely to support the Committee's work. In setting the scope of its study, the Subcommittee considered the scope of the Committee's overall work and practical limits on the resources and time available to the Subcommittee.

The Subcommittee limited the scope of its study about users' needs to only certain users. Specifically, the Subcommittee focused on professional investors and creditors, and their advisors, who follow fundamental approaches and who cannot compel the company to produce the information needed for analysis. The Subcommittee further restricted its focus to users' evaluations of only certain reporting entities - specifically, to for-profit entities. The scope of the Subcommittee's work and the reasons for that scope are discussed in Section I, "Scope of the Subcommittee's Study About Users' Needs for Information."

Basis for Analysis

The Subcommittee's analysis of the information needs of investors and creditors is based on the Subcommittee's database of materials on users' needs for information dated June 22, 1993. That database is based, in turn, on the Subcommittee's research activities over the last eighteen months. Each of those activities resulted in materials, all or a portion of which were included in the database. The introduction to the database lists those materials. Also see Section II, "Activities that Provide the Basis for Analysis," which discusses the scope of the Subcommittee's research activities and the reasons why the Subcommittee undertook certain projects and rejected others.

Guiding Principles

The Subcommittee prepared the preliminary analysis following certain guiding principles:

1. Capture all views that can reasonably be inferred based on the materials in the database. Identify a comprehensive list of views even though some may conflict with others.

2. Flag inconsistent views and recommend how those inconsistencies should be resolved.

3. Identify the reasons supporting each view listed in the analysis. Cross-reference those reasons to the applicable sections of the database so that a reader can evaluate the support for a view.

4. Draft entries into the analysis in outline and bullet point format. Be concise.

5. Design the analysis to facilitate review and use by the Committee.

Organization

To facilitate both the analysis and the Committee's use of the analysis, the analysis is divided into the same categories and subcategories as used in the database.

The analysis also includes a section that captures general views of users' needs for information that are pervasive and apply to many or all of the categories in the database (see Section III, "General Views of Users' Needs for Information)

Leading and Alternative Views

The analysis identifies two kinds of views about users' needs for information: leading views and alternative views.

The Subcommittee determined leading views based on the following subjective criteria:

1. The view held by the majority of users

2. The strength of the arguments offered in support of a view

3. The consistency of the arguments supporting a view.

Although in concept leading views could conflict with the majority position, in practice this was not often the case. Most often, the majority view was also supported with well-reasoned positions.

Within a topic, the Subcommittee often identifies more than one leading view. In those cases, the leading views do not conflict. Rather, they address different issues within the more general topic.

In contrast to leading views, alternative views are held by a significant minority of the user group, or in rare cases, if held by the majority, are not supported by compelling arguments. Alternative views always conflict with leading views.

The Subcommittee suggests that the Committee develop, to the extent possible given cost/benefit constraints, recommendations that are consistent with leading views. Nevertheless, the Subcommittee decided to include alternative views in the analysis (1) to alert the Committee to cases where a significant group of users disagree with the leading view and (2) to permit the Committee to evaluate the Subcommittee's conclusions about leading views.

AICPA Special Committee on Financial Reporting
Users' Needs Subcommittee
Analysis of the Information Needs of Investors and Creditors
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I. Scope of the Subcommittee's Study of Users' Needs for Information

The Subcommittee undertook its study of users' needs for information solely to support the Committee's work and not to study users' needs for information per se. In setting the scope of its study, the Subcommittee considered the scope of the Committee's overall work and practical constraints over the resources and time available to the Subcommittee. This section addresses the scope of the Subcommittee's study of users' needs for information and the nature and reasons for limits on that scope.

The Subcommittee limited the scope of its study about users' needs to only certain users. Specifically, the Subcommittee focused on professional investors and creditors, and their advisors, who follow fundamental approaches and who cannot compel the company to produce the information needed for analysis. The Subcommittee further restricted its focus to users' evaluations of only certain reporting entities-specifically, to for-profit entities. Those limitations are discussed below.

Investors and Creditors

The users of external reporting are a highly diverse group. Various dimensions capture that diversity, such as the many reasons why users rely on external reporting. The following summarizes some of those reasons:

Type of User	Reason for Using External Reporting
Investors	Helps with investment-related decisions
Creditors	Helps with credit-related decisions
Management and Board Members	Helps with decisions about managing the business
Employee Groups	Helps with understanding of compensation policies and the reporting entity's ability to increase compensation
Competitors	Helps evaluate competitive strengths and weaknesses and business strategy
Regulators	Helps assess compliance with regulations
Academics	Provides data for research
Auditors	Helps understand reporting practice
The Press	Provides data for articles
Users Concerned With Various Social Causes	Helps assess the reporting entity's involvement in areas of concern with various social issues

The above list is not comprehensive. No doubt there are many more reasons why users use external reporting than listed above.

The full Committee has decided to focus on improving external reporting for purposes of helping users with investment and credit decisions and to not consider other reasons for improving external reporting. It did so for three reasons.

First, the AICPA Board formed the Committee primarily to address concerns about the relevance of external reporting in making investment and credit decisions. The Committee decided to adopt the same focus to meet the Board's expectations.

Second, the traditional focus of external reporting has been to assist users in making investment and credit decisions, thereby helping ensure that capital is allocated efficiently and effectively. The Committee viewed the traditional role of external reporting as serving a critical function and saw no reason to change that traditional focus of external reporting through its work.

Third, the Committee's resources and time were limited. Thus, the Committee decided to focus on the traditional role of external reporting in assisting investors and creditors rather than spending its resources to improve external reporting for other users.

The Subcommittee limited the scope of its work to the information needs of investors and creditors consistent with the Committee's direction.

Professional Users

The Subcommittee focused on the information needs of professional users rather than nonprofessionals who use external reporting to make decisions for their personal benefit and not as part of their employment. The Subcommittee agreed to focus on professionals for four reasons.

First, the Subcommittee believes that professionals have more extensive needs for information than nonprofessionals. The Subcommittee specifically considered whether nonprofessionals have a need for more summarized or condensed reporting compared to professionals, and if so, whether focusing on professional investors would overlook that difference in information needs. The Subcommittee noted the results of studies performed over the years indicating that nonprofessionals reject the idea of summarized or condensed reporting on their behalf. Thus, in general, external reporting that satisfies the information needs of professionals will also satisfy the information needs of nonprofessionals. The Subcommittee noted that the 1987 survey by SRI International,

Investor Information Needs and the Annual Report, supports that conclusion.

Second, the percentage of total capital available for investment that is controlled by professionals has increased dramatically over the last two decades. That trend has resulted in part from the popularity of mutual funds that have served to concentrate large amounts of capital under the control of relatively few professional investors. Because of that concentration, professionals are more likely to determine the prices of securities than are nonprofessionals. Since the Committee's mission related to external reporting serves the broader goal of ensuring the efficiency and effectiveness of capital allocation, the Committee should study the information needs of professionals who drive that allocation.

Third, many non-professionals rely on the advice of professionals such as analysts, brokers, and others in making decisions. Further, because of the increasing complexity of the marketplace and the accelerating pace of change, nonprofessionals may rely increasingly on professionals for advice. Thus, professionals often heavily influence the decisions of nonprofessionals, even though they may not make the decision themselves.

Fourth, professionals, because of their training and full-time focus, should be better able to articulate their needs for information and the reasons for those needs than should nonprofessionals. Further, professionals are more likely to document their procedures and the information they use and to write about those procedures and information needs and uses than are nonprofessionals. Thus, professionals offer more information about their needs for information than do nonprofessionals.

Approaches to Decision Making

Not all investors and creditors use external reporting to help with their investment and credit decisions. The type of approach used in making the investment or credit decision determines whether the investor or creditor requires information found in external reporting. For example, some approaches require no company-specific information or company-specific information of the type that is outside the scope of external reporting. Examples of approaches that do not require information from external reporting include:

Approach Used in Making Investment or Credit Decisions	Types of Information Required to Support the Approach Used
1. Index fund approach whereby investors and creditors seek to duplicate the performance of an index, such as the S&P 500	The identities of securities necessary to mimic the performance of the index
2. Approaches that predict future price changes for securities based on historical patterns of security prices or historical correlations of security prices to certain phenomena. Those approaches often use charts and graphs as tools to understand those historical patterns and correlations.	Historical patterns of prices for specific securities
3. Technical approaches that predict short-term changes in the supply or demand of particular securities as a means to predict changes in the prices of those securities	Number of a particular security sold short, margin position for a security, purchases or sales of a security by insiders, and other leading indicators useful to predicting changes in the supply and demand for securities
4. Approaches that use predictions of changes in interest rates as a means to predict changes in the prices of debt securities	Predictions of changes in interest rates

On the other hand, other approaches require extensive amounts of company-specific information of the types commonly found in external reporting. Examples of those approaches include:

1. Fundamental approaches that seek to value a security by assessing the amount, timing, and uncertainty of future cash flows or income that will accrue to that security

2. Anticipation approaches that predict an entity's short-term earnings, changes in earnings, and changes in trends of earnings as a means to predict short-term changes in the prices of its securities.

The Subcommittee decided to focus on investors and creditors who follow fundamental approaches because other approaches generally do not require information from external reporting and would be mostly irrelevant to the Committee's work. One exception is the anticipation approach, which requires information from external reporting to predict short-term earnings. However, because of the short-term focus of the anticipation approach, it is reasonable to believe that the information needs of that approach are either the same or a subset of those of the fundamental approach. Thus, the Subcommittee concluded that it would gain little incremental benefit from a separate study of investors and creditors who follow the anticipation approach.

Advisors

The Subcommittee considered whether to also focus on users of external reporting who advise investors and creditors, even though they are not investors or creditors themselves. Those advisors include analysts, brokers, accountants, portfolio strategists, industry consultants, and others. The Subcommittee concluded that advisors often serve an integral role in the investors' and creditors' decision-making process. Further, it noted that certain advisors, particularly analysts, are among the most important users of external reporting. Thus, the Subcommittee decided to also focus on the advisors to investors and creditors, particularly analysts, to the extent that their approach to developing advice requires information from external reporting.

Ability to Compel Delivery of Information Needed for Analysis

Some investors and creditors can compel entities to deliver the information they need for analysis. Examples include investors with large ownership, investors and creditors with sufficient bargaining power, such as venture capitalists, bankers when considering an initial loan to risky credits, and rating agencies. On the other hand, other investors and creditors cannot compel the delivery of information. They must rely on mandated reporting, the willingness of the company to provide information, and sources outside the company for the information they need to make decisions.

The Subcommittee concluded that the purpose of mandated external reporting is first to serve the information needs of those who cannot compel entities to deliver the information they need for analysis. Those who can compel the production of information can generally help themselves. Thus, the Subcommittee concluded that it should focus on investors and creditors who cannot compel entities to deliver information.

Although the Subcommittee's focus is on those who cannot compel, it nevertheless decided to include in its study of information needs those who can compel, such as representatives of the rating agencies. It did so for two reasons. First, it is reasonable to believe that the information needs of both groups are similar. For example, the Subcommittee expects that a rating agency and a company's bondholders have similar needs for information about the company, particularly since the rating agency is evaluating the company on behalf of the bondholders. Second, investors and creditors who can compel the delivery of information may offer particular insights about the types of information that may be useful to others but that is not currently part of mandated external reporting and should be considered for inclusion.

For-Profit Entities

The Committee decided to limit the scope of its work to the external reporting of for-profit companies and has excluded from its consideration reporting by not-for-profit organizations and governmental entities. It limited its scope solely because of practical constraints on the time and resources available to complete the work. The Committee nevertheless believes that external reporting by not-for-profit organizations and governmental entities is of critical importance. It hopes that the Committee's recommendations related to reporting by for-profit companies will assist others in recommending improvements in the reporting by not-for-profit organizations and governmental entities.

Consistent with the Committee's overall scope, the Subcommittee decided to limit its study to the information needs of users in evaluating for-profit companies.

II. Activities That Provide the Basis for Analysis

The Subcommittee's analysis of the information needs of investors and creditors is based on the Subcommittee's database of materials on users' needs for information dated May 17, 1993. That database is based, in turn, on the Subcommittee's activities over the last eighteen months, which fall into five broad categories:

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

2. Formal meetings with the Subcommittee's Investor and Creditor Discussion Groups

3. Meetings 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

4. Informal meetings with other investors and creditors

5. Research sponsored by the Subcommittee about the types of information included in analysts' formal reports about companies.

This section discusses the scope of those activities and the reasons why the Subcommittee undertook certain projects and rejected others.

Study and Analysis of Documents Written by Investors and Creditors or Based on Research Directly with Investors and Creditors about Their Needs for Information

The Subcommittee began its study with a literature search of books and articles, focusing on those that suggested improvements in external reporting. The Subcommittee built an automated database of that literature, including references to over 200 documents, and analyzed the contents of the database.

Unfortunately, the initial database of information was not able to provide sufficient information about the information needs of investors and creditors. Few of the materials in the database were written by investors or creditors or based on research directly with investors or creditors (direct documents). Rather, the materials were generally written by accountants, standard setters, regulators, and academics. The recommendations in the materials by those authors were usually based on accounting theory or intuition rather than on the information needs of investors and creditors. Relatively few of the articles referred to the users of financial statements. Those that

did usually speculated about what would be helpful to users rather than basing recommendations on direct research with users.

The Subcommittee concluded that its initial literature search and database did not provide sufficient data on which to base its report to the Committee on the information needs of investors and creditors. As a result, the Subcommittee undertook a second literature search, focusing on direct documents.

The second literature search surfaced some relevant direct documents. However, the Subcommittee concluded that those documents alone did not provide a sufficient basis on which to report to the Committee. Thus, the Subcommittee concluded that it would need to supplement the information in the direct documents with additional research about the information needs of investors and creditors either performed directly or sponsored by the Subcommittee. That conclusion resulted in the activities described in the following sections.

Meetings with the Subcommittee's Investor and Creditor Discussion Groups

In the Fall of 1992, the Subcommittee formed two groups of users for a series of formal face-to-face meetings to:

1. Obtain answers to questions and cover in more depth issues about the information needs of investors and creditors that had surfaced from the Subcommittee's analysis of research

2. Obtain investors' and creditors' reactions to the Subcommittee's tentative conclusions about the information needs of investors and creditors and the Committee's preliminary recommendations to improve external reporting

3. Provide a vehicle for the Subcommittee to meet other investors and creditors for additional follow-up and in-depth discussions.

In forming the groups, the Subcommittee sought participants with diverse experiences and perspectives. The twelve members of the Subcommittee's Investor Discussion Group included portfolio managers and buy- and sell-side analysts with experience in a variety of industries. Further, the fifteen members of the Creditor Discussion Group included bankers from large and small institutions, debt security analysts, analysts from rating agencies, and an analyst involved in issuing performance bonds.

The Subcommittee met with the Investor Discussion Group on four occasions from October 1992 to March 1993 and the Creditor Discussion Group on three occasions

from December 1992 to March 1993. Also, in April 1993, the Subcommittee met once with a separate group of both investors and creditors to discuss value information. Each meeting lasted four hours.

The Subcommittee followed the same format for each meeting with the investors and creditors. Premeeting materials identified questions to be discussed and alternative responses to those questions. At the meetings, participants discussed their views on the questions and the reasons for those views. Following each meeting, the staff prepared transcripts and meeting summaries. Further, participants completed questionnaires that followed up in more depth on points raised during the meetings. The Subcommittee's database includes both the transcripts and responses to the questionnaires.

Meetings with the Financial Accounting Policies Committee of the Association of Investment Management and Research and the Accounting Policies Committee of the Robert Morris Associates

The Committee met with two trade organizations that represent significant numbers of investors and creditors: (1) the Financial Accounting Policies Committee of the Association of Investment Management and Research (AIMR), representing portfolio managers and analysts, and (2) the Accounting Policies Committee of the Robert Morris Associates (RMA), representing bankers.

The Subcommittee met with those organizations to (1) determine whether their views are representative of the views of a wide range of the organizations' memberships, (2) identify additional direct documents for the Subcommittee's study and analysis, and (3) provide a vehicle for the Subcommittee to meet other investors and creditors for additional follow-up and in-depth discussions.

At the time of the meeting, the AIMR was in the process of developing a position paper summarizing its views related to external financial reporting titled Financial Reporting in the 1990's and Beyond. The AIMR has since circulated the paper for comments from its members. Major portions of the paper are included in the Subcommittee's database. The meeting with AIMR also identified several more direct documents for the Subcommittee's consideration, including the Annual Reports of the AIMR's Corporate Information Committee, portions of which are also in the database. Finally, the meeting resulted in a number of contacts with investors that proved helpful later in identifying people to serve on the Subcommittee's Investor Discussion Group.

The RMA and the Subcommittee discussed several technical matters that resulted in a subsequent exchange of correspondence, portions of which are included in the Subcommittee's database. Apart from that correspondence, the meeting with RMA

identified no additional direct documents for the Subcommittee's consideration. However, the meeting resulted in a number of contacts with creditors that proved helpful later in identifying people to serve on the Subcommittee's Creditors Discussion Group.

Meetings with Other Investors and Creditors

Subcommittee members and staff also met on an informal basis with certain analysts. Specifically, several members and staff spent a day interviewing and observing sell-side analysts at two large brokerage and investment banking firms. Members and staff also met individually with a buy-side analyst from an investment management firm and a sell-side analyst who is well known in the European Community. Each of those meetings resulted in materials that summarized key points of the discussion. Portions of those materials are included in the Subcommittee's database.

Research about the Types of Information Included in Analysts' Formal Reports about Companies

The subcommittee concluded that a study of analysts' reports would help identify the types of information that analysts find useful. As a result, the Subcommittee sponsored research about the types of information included in analysts' formal reports about companies.

The research was performed by a team of academics. The team analyzed hundreds of sell-side analysts reports that are included on an automated database, and they summarized their conclusions in their report, "A Content Analysis of Sell-Side Financial Analyst Company Reports," dated December 1992. Major portions of that report are included in the Subcommittee's database.

Projects not Undertaken

The Subcommittee believes that the research resulting from the five types of activities discussed above provides a reasonable basis for its conclusions about the information needs of investors and creditors. Thus, the Committee can rely on those conclusions in developing recommendations to improve external reporting.

However, the Subcommittee's study of the information needs of investors and creditors is by no means comprehensive. The Subcommittee's conclusions are in some areas incomplete. Further, in many areas the reliability of the Subcommittee's conclusions could be significantly improved with additional work to confirm those conclusions. Finally, as noted in the analysis, some of the research resulted in inconsistent views from users. Further work in those areas could reduce those inconsistencies.

The Subcommittee believes that further research related to users' needs for information could provide critical information to those who are charged with maintaining the relevance of external reporting. The Subcommittee did not undertake additional research because of practical constraints on time and resources available to the Subcommittee, and not because it was unhelpful. The following examples illustrate the types of additional research that the Subcommittee believes would provide useful information:

1. Study of the types of information that companies voluntarily supply to investors and creditors that are not currently part of mandated external reporting. (The Subcommittee sponsored research in this area. However, because of delays in getting data from participating companies, the results of the research are not yet available.)

2. Research about the information needs of investors and creditors related to not-for-profit organizations and governmental entities.

3. Study of the types of information that companies provide to investors and creditors when seeking capital at critical stages, such as initial start-up, initial public offerings, responding to a hostile tender offer, major business combinations and reorganizations, and bankruptcy.

4. Statistically valid surveys of investors and creditors to gather or confirm findings about their needs for information.

5. Fieldtesting with investors and creditors the Committee's recommendations to improve external reporting.

6. Study of literature from non-U.S. authors related to the information needs of investors and creditors.

7. Study and summary of empirical evidence about the correlation between external reporting and the cost of capital.

8. Study and summary of empirical evidence about the correlation between types of information in external reporting and the quality of decisions by investors and creditors.

III. General Views of Users' Needs for Information

Relevance of Information

Users' have diverse needs for information depending on (a) the users' objective and approach, (b) the security being evaluated, and (c) the reporting company's unique situation.

Many sophisticated users say they want all possible information. Although that request is impractible, it reflects a willingness of users to wade through all information to identify that which is useful from that which is not. They prefer access to all information in case some of it is useful, rather than having access only to core information that in general is always useful.

Despite the diversity of users' needs for information, many users, particularly those who predict a company's earnings or cash flows, when evaluating many securities and many companies in many situations, have common needs for company-specific information. The following points outline the types of that information that is often relevant.

1. Users need a foundation of knowledge about the past and the present on which to evaluate alternative predictions about the future. The major components of that foundation are (a) the segment's business, methods of conducting the business, and its relationships with others, (b) financial and operating statistics for recent periods, and (c) explanations of relationships and changes among the statistics between the periods. The details of those components are outlined in Section 13, "Nonfinancial Business Information," under the caption "Information about the Past and the Present."

2. Users also need information about leading indicators. Leading indicators are conditions that already exist, but that help users make projections about the future. Leading indicators include (a) the identity and possible effect of key trends, (b) the company's broad goals, strategy, and factors that are critical to successful implementation of the strategy, (c) major plans, and (d) opportunities and risks. The details of those components are outlined in Section 13, "Nonfinancial Business Information," under the caption "Forward looking Information."

3. Users also need projected financial and nonfinancial information. Often the projected information is a direct input into the users' decision approach. Investors and creditors use the information in (1) and (2) above to either prepare the projections themselves or evaluate projections by others.

4. Disaggregation of information is key to making reliable estimates and evaluations of future measures. Users need two types of disaggregated information:

   (a) Users need information on an industry basis and, in some cases, a geographic and line of business basis. In general, users need information for each part of the business that has different opportunities and risks from other parts. To the extent possible, users want to evaluate industry and geographic segments as separate businesses.

   (b) Users also need a sufficient level of detail of information about the company's businesses. For example, in financial statements, it is not sufficient to report only net income. Rather, users also need the components of net income, including revenues, expenses, gains and losses. Sufficient detail allows users to better understand the business and to distinguish between recurring and unusual aspects of the business.

   The need for disaggregated information applies to all periods and all types of information (historical and forward looking, and financial and nonfinancial).

5. Although users generally prefer quantitative information, they also need qualitative information, particularly in areas not easily expressed in quantitative terms, such as business strategy.

6. Measurements must be comparable and consistent. Users are as much interested in relative as absolute performance. Assessing relative performance means that measures must be made consistently over time and be comparable to those of other companies.

7. Information must be timely. Timely information often provides an early warning of changes in conditions. The timeliness of information is becoming more critical as the rate of change accelerates. In concept, users would like all information as soon as available. As a practical matter, users generally need updated information quarterly. Further, for critical transactions and events, users need to be updated immediately.

8. Users need information over a sufficient time frame. In general, the users need historical information for sufficient historical periods to permit analysis of how the segment's business performed through one or two business cycles (often about ten years). The number of periods of forward looking information that users need depends on their objectives and approach, but rarely exceeds five years.

Reliability of Information

1. Users do not exclude from their consideration relevant information solely because it is inherently subjective and unreliable. However, users expect that relevant information that is verifiable will be verified by preparers and, in many cases, others.

2. Users support auditing as an important way to increase the reliability of information.

3. Users need to understand the relative reliability of information (measurement uncertainties).

Sources of Information

1. Users need multiple sources of information because:

   (a) Users want information from the best source, and some sources are better than others, depending on the type of information

   (b) The same type of information from multiple sources allows the user to compare and contrast views and assess the reliability of the information.

2. Users usually need information from management in addition to other sources because:

   (a) Management is closest to the business and is the best source for many types of information

   (b) Management's perspective helps the user understand where management will lead the company.

External Reporting

1. For most users, financial statements provide critical information. Despite differences in users' needs for information, financial statements are flexible enough to provide important information to most users.

2. The Subcommittee has learned a great deal about users' needs for information. However, it has relatively little information about the costs of providing that information. Thus, the Subcommittee cannot recommend which portions of the information needs of users should be required in external reporting.

USERS' NEEDS FOR INFORMATION RELATED TO SPECIFIC CATEGORIES

1. Objectives and Approaches of Users

1(a). Investors' and creditors' objectives and approaches

<u>Leading view</u>

1. *The fundamental objectives of investors, creditors, and their advisors (the users) differ depending on whether they are evaluating debt or equity securities. Major, recurring objectives of include:*

    - *Investors form opinions about the absolute and relative value of companies and their equity securities*
    - *Creditors assess the ability of a company to meet its obligations related to current or future debt or other financial instruments through timely payment of principal and interest or, as a last resort, through transfer of a collateralized asset.*

2. *The objective of external reporting is to provide information that is useful to present and potential investors and creditors in deciding whether or not to commit, or continue to commit, resources to a particular company.*

3. *The users are a diverse group, as illustrated in Exhibit 1(a)-1. Because of that diversity, users employ different approaches to accomplishing their objectives. The particular approach used depends on the (a) users' objectives, (b) instrument being evaluated, (c) company's industry and circumstances, and (d) users' personal preference.*

4. *Some of the approaches that investors use to assess a company's value include:*

    - *apply a multiple to the company's current or projected earnings, core cash flows, or adjusted reported equity*
    - *project the company's future cash flows and residual value and discount at a risk-adjusted cost of capital*
    - *adding to or subtracting from the value of future core earnings or cash flows the estimated values of non-operating resources or obligations*
    - *total the values of the company's major assets and subtract the value of the company's debt*
    - *identify recent favorable or unfavorable developments the market price does not yet reflect*

- *identify probable short-term price changes through indicators involving financial measurements, such as the momentum in the company's earnings*
- *combinations of the above.*

5. *Some of the approaches that creditors use to assess a company's ability to meet its obligations include:*

- *compare the company's current or projected earnings to current or projected fixed charges*
- *compare the company's current or future cash flows to current or future debt service requirements*
- *assess the company's ability to raise cash from the sale of assets*
- *assess the company's ability to raise capital*
- *assess the company's ability to meet lending agreement covenants*
- *combinations of the above.*

1(b). Types of information that investors and creditors use and the relative usefulness of that information

1. *Users have diverse needs for information. The information that a user needs depends on the (a) user's approach to achieving his or her objectives, (b) instrument being evaluated, (c) company's industry and circumstances, and (d) user's personal preference. Exhibit 1(b)-1 discusses how those factors can impact the information that users need.*

2. *Despite the diversity of users' needs for information, many users, particularly those who predict a company's earnings or cash flows, when evaluating many securities and many companies in many situations, have common needs for company-specific information. The types of that information is identified and discussed in Section 13, "Nonfinancial Business Information". The relative usefulness of a particular piece of information depends on the factors listed in (1) above.*

1(c). Investors' and creditors' use of information to achieve their objectives

Note: The following describes how investors and creditors use each of the major types of information listed in Section 13, "Nonfinancial Business Information". Not all investors and creditors use all of the information listed. Further, our descriptions of how investors and creditors use information is no doubt incomplete.

The segment's business, methods of conducting the business, and its relationship with others

(i) Users use information about the company's operating activities to understand the relationship between those activities and the company's financial results, which in turn helps users predict the financial impact of trends

(ii) Users also use information about the company's operating activities to identify opportunities and risks that could result from those activities and to spot companies that may be impacted by trends

(iii) Users use information about the company's resource providers, customers, competitors and potential competitors to identify opportunities and risks that could result from those parties and spot companies that may be impacted by trends

(iv) Users use information about major shareholder, director, and management interests, relationships, and incentives to identify conflicts of interests, and assess whether shareholders', directors', and management's interests are consistent with those of the user.

Financial statements and related notes

(i) Users use financial statements to understand the relationship between the company's financial results and its physical activities, which in turn helps users predict the financial impact of trends

(ii) Users use financial statements to determine the company's historical core earnings or cash flows as a basis for predicting future earnings or cash flows

(iii) Users also compare the company's financial statements over time to identify key trends that are impacting the company

(iv) Users also comparing the company's financial statements to those of other companies to identify the company's strengths and weaknesses, and identify the opportunities and risks that may result from those strengths and weaknesses

(v) Users also analyze the company's financial statements to assess the company's ability to pay its debts when due and to identify the types of assets that may be available to secure debt.

Key nonfinancial statistics

(i) Users analyze nonfinancial data to understand and quantify the company's activities. Users then relate those activities to the company's financial results, which helps users predict the financial impact of trends

(ii) Users also compare the company's nonfinancial data over time to identify key trends that are impacting the company

(iii) Users also compare the company's nonfinancial data to those of other companies to identify the company's strengths and weaknesses, and identify the opportunities and risks that may result from those strengths and weaknesses

(iv) Users also analyze nonfinancial data related to the company's assets to identify the assets that may be available to secure debt.

Explanations of relationships and changes among financial and nonfinancial statistics between periods

(i) Users use explanations of changes among financial and nonfinancial statistics to understand what happened that caused financial and operating data to change between periods, which in turn helps the user assess whether relationships, trends, and changes will continue in the future.

Identity and possible effect of key trends

(i) Users use information about the identity and possible effects of key trends to project nonfinancial and financial results.

Major goals, strategy, factors that are critical to successfully implementing the strategy, and major plans

(i) Users use information about mission to understand management's overall goals for the company, and to identify opportunities and risks from the company's potential activities

(ii) Users use information about the company's strategy to predict the company's future direction and to identify opportunities and risks

(iii) Users analyze factors that are critical to successfully implementing the company's strategy to assess the likelihood that the strategy will succeed and to identify opportunities and risks

(iv) Users use information about the company's major plans to predict the company's future direction and assess the opportunities and risks of its future activities.

Opportunities and risks

(i) Users use information about opportunities and risks to predict nonfinancial and financial performance and to assess the uncertainty of that performance. The uncertainty of that performance is a key component in the approach used by many investors and creditors.

Measures of leading indicators, such as backlog

(i) Users use leading indicators to predict operating and financial performance.

Projected financial and nonfinancial information (the types and periods are dependent on the users' objective and approach).

(i) Users use projected nonfinancial information to project financial information
(ii) Users use projected financial information as a key component in their approach to achieve their objective.

Exhibit 1(a)-1

Diversity of Investors, Creditors, and Their Advisors

The investors, creditors, and their advisors who use external reporting (the users) are a diverse group. Various dimensions capture that diversity. Examples of those dimensions include: (i) their employers and roles, (iii) their backgrounds, (iv) the type of instruments they are evaluating, (v) the types of entities they are evaluating, and (vi) their timeframes. The following examples within each of those dimensions illustrate the diversity within the user group:

Employers and Roles

Users are employed by diverse organizations, examples of which follow:

1. Broker-dealer firms - sell-side analysts; brokers; dealers
2. Investment banking firms - sell-side analysts; underwriters; investment bankers
3. Pension funds, mutual funds, and insurance companies - buy-side analysts, fund managers
4. Banks and finance and leasing companies- analysts; loan officers; loan committee members
5. Performance bonding companies - analysts; bonding officers, approval committee members
6. Rating agencies - analysts; rating committee members
7. Companies - credit analysts; credit committee members; strategic planners, purchasing agents.

And users serve various roles within those organizations, such as:

1. Analyze industries, companies, instruments and situations, and recommend actions to others (analysts and strategic planners)
2. Decide which securities to buy and sell (fund managers, investment bankers)
3. Generate business (brokers, underwriters, loan officers, bonding officers)
4. Decide whether to extend credit (loan committee members, approval committee members, credit committee members)
5. Rate the credit worthiness of a particular security (rating committee members)
6. Decide whether to do business with a vendor (purchasing agents).

Backgrounds

Users have diverse backgrounds reflecting the diverse nature of the skills required. Examples of those backgrounds include economists, operating management, financial

management, strategic planners, consultants, analysts, public accountants. mathematicians and statisticians, and no formal experience.

Type of Investments

In recent years, there has been an explosion in the number and types of financial instruments with which users are associated. A few examples of the major classes of those instruments follow:

1. Debt
2. Equity
3. Options
4. Forward contracts
5. Swaps
6. Guarantees and commitments
7. Derivative instruments
8. Convertible instruments
9. Marketable and nonmarketable instruments
10. Short-term, medium-term, and long-term instruments
11. Secured and unsecured instruments.

Types of Entities Under Evaluation

Users evaluate securities from every type of entity in every circumstance. The following list illustrates the diversity of those entities and circumstances.

1. Entities in every industry (not-for-profit and governmental are outside the scope of the Committee's work)
2. Small and large
3. Public and private
4. Start-up and established
5. Successful and unsuccessful
6. Domestic, foreign, and international
7. Single segment and conglomerates
8. Corporations, partnerships, joint ventures
9. Regulated and nonregulated
10. Subsidiaries and parent companies.

Timeframes

Users have very diverse timeframes for their analysis of the future. The users' timeframe often depends on the instrument under evaluation, and the users' objective and approach. For example, some creditors assess whether a company can meet its

obligations over only a few days or months, whereas others are concerned with many years. As another example, some investors assess a company's long-term potential, whereas others seek to determine whether the company's stock price will rise or fall over the next few months.

Exhibit 1(b)-1

Diversity of Users' Needs for Information

Users have diverse needs for information. The information that a user needs depends on the (a) user's approach to achieving his or her objectives, (b) instrument being evaluated, (c) company's industry and circumstances, and (d) user's personal preference. The following discusses how those factors can impact the information that users need.

Approach

The approach used by investors and creditors sometimes impact their needs for information.

For example, contrast the information needs of investors who follow the earnings momentum approach as a means of predicting short-term stock price changes with those of an investor following the fundamental approach as a means of determining the longer-term value of a company's stock. The first investor probably has extensive needs for information that helps predict near-term earnings. Yet, he probably needs little about the expected long-term impact of key trends. In contrast, investors following the fundamental approach are probably less preoccupied with predicting near-term earnings, but need far more information about the long-term impact of key trends.

As another example, consider investors who total the values of the company's major assets and subtract the value of the company's debt as a means of valuing companies. Those investors need information about the identity and values of individual assets and liabilities. In contrast, investors who value companies by applying a multiple to projected earnings may need relatively little information about those values.

Nature of Instrument

The nature of the financial instrument under analysis often impacts users' needs for information.

For example, contrast the information needs of a bank which is evaluating a potential loan to an excellent credit risk and a potential investor of that same company's stock. Under any scenario, the company's cash flows are more than sufficient to pay its debts when due. Under those conditions, the bank may require no more than recent audited financial statements, and may use those statements only to verify certain key financial ratios. Because of the large cushion of excess cash flows, the bank may not need financial projections. Further, the bank may need little information about risks if it judges those risks to be minimal in relation the excess cash flows. Finally, the bank

may need no information about the company's opportunities. In contrast, the investor may need more extensive information. The investor may need sufficient information to project the company's earnings, and detailed information about both its risks and opportunities to judge the uncertainties of those earnings.

As another example, contrast the information needs of short-term and long-term creditors. For example, consider a creditor who may buy a company's 60 day commercial paper, and a second creditor who is considering a new issue of the same company's 10 year secured bonds. Although both creditors must assess the risk of the company not being able to pay its debts when due, the first creditor's needs for information is less than the second. The first creditor can probably make a decision based on a fairly brief review of recent financial statements, and some inquiry of the company's experience with issuing commercial paper in the past. In contrast, the second creditor needs to understand longer-term trends that may affect the company and assess what the impact of those trends may be. Unlike the first creditor, the second needs to evaluate the adequacy of the company's security interest.

The Company's Industry and Circumstances

The following examples illustrates how the company's industry and circumstances can impact the users' needs for information.

The company's circumstances can impact the extent to which investors need historical information about the company. In most cases, historical financial and nonfinancial business information over a ten year period provides a foundation on which the users can evaluate the future. However, in the cases of some companies, recent circumstances have changed so much that historical information is not as helpful in predicting the future. Those cases often involve start-up companies; cases in which changes in technology has redefined the market, product, or production process; companies emerging from dramatic restructuring, such as bankruptcy; and companies with new management.

A company's circumstances can also impact the extent to which the user needs information about the value of certain assets. In many cases, the historical cost of assets provides useful information and users have little need for the values of those assets. However, in some cases, the value of a company is based on the value of a few key assets or classes of assets. Examples include some natural resource companies for which the values of proved reserves or deposits drives the value of the company. In those cases users will need information that helps them value the key assets.

A degree of a company's success and financial strength can also impact users' needs for information. For example, creditors evaluating a company that is highly profitable, growing, financially strong, and has excellent prospects may need only limited

information. That information could be limited to financial statements with little analysis and no projections of the future because the risk of the company not being able to meet its obligations when due is remote. On the other hand, creditors evaluating a company that marginally profitable, stable, highly leveraged, with average prospects may need more extensive information.

Personal Preferences

Another factor impacting the users' needs for information are the users' personal preference. Two users may be evaluating the same security using the same approach, and yet have different needs for information because they assess facts differently, emphasize different matters, or have different timeframes for their analysis.

For example, one investor may use historical data for the last ten years, to observe how a company reacted in periods of recession and expansion. Another investor uses historical data for only the last three years because new management greatly changed the company's operations at that time.

In another case, one investor projects future income by using operating data as much as possible. That investor projects future sales in units and separately estimates selling prices, costs and expenses that the company will incur to support that volume. That investor uses operating data for several historical and future periods. In contrast, another investor projects future income using only the data in financial statements, and based on discussions with management. That investor rarely uses operating data.

In a third case, one investor holds securities for about one year on average. Another investor holds securities for about seven years on average. The first investor is primarily concerned with events that will affect the company within the next one to two years. In contrast, the second investor needs information about the expected longer-term impact key trends.

2. Qualitative Aspects of External Reporting

<u>*Leading View Reflected in the Four Topics under this Title*</u>
Investors, creditors, and their advisors 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. That concern extends to the ingredients of those primary qualities, such as representational faithfulness and verifiability, which are ingredients of reliability, and timeliness and predictive and feedback values, which are ingredients of relevance. Many investors, creditors, and advisors are familiar with and generally accept the descriptions of those qualities of useful information in Concepts Statement No. 2, Qualitative Characteristics of Accounting Information.

2(a). Relevance

Note: Relevance of information for investment and credit decisions is a major subject of the entire database. The meeting materials and postmeeting questionnaires sent to members of the investors and creditors groups contained no questions about relevance as a quality of useful information of the kind asked about reliability, comparability, and conservatism but did contain questions about relevance of particular kinds of information and about information in particular circumstances. Thus, comments and observations about relevance by investors, creditors, and other users are included at least to some extent in most subcategories and are prominent in some, such as, **section 1(b)**–Types of information that investors and creditors use ... , **section 3**–Disaggregated information, **section 5**–Display, **section 6**–Unconsolidated entities, **section 10**–Operating opportunities and risks, **section 11**–Interim reporting, **section 12**–Forward looking information, and **section 13**–Nonfinancial business information. The nine pages in this subcategory of the database therefore contain some comments about the relevance or lack of relevance of specific kinds of information that is more fully considered in other categories of the database. They also contain some general observations and comments about relevance and about the relationship between relevance and reliability.

The relevance issue of greatest immediate concern to many investors and their advisors, and also probably to many creditors and their advisors, pertains to quarterly reporting and commonly is described as an issue of timely reporting. Timeliness is an ingredient of relevance in Concepts Statement 2, and many investors, creditors, and their advisors feel that timely reporting is threatened by those who blame quarterly reporting requirements in the United States for "short-termism" and advocate semiannual reporting, which is more common in other countries. Concerned investors, analysts, and their advisors argue that the blame for "short-termism" can better be placed elsewhere, that timeliness of reporting is essential to financial analysis, that quarterly reporting is

optimal, and that quarterly reporting needs to be improved in several ways but most particularly by requiring quarterly disaggregated information. Some comments and observations on that issue appear in this section of the database, but most of the comments and observations and consideration of the issue are included in **section 11–Interim Reporting** and are not included or considered here.

Leading view

Accounting and other information must be relevant to investment, credit, and similar decisions to be useful to investors, creditors, and their advisors. It also must have other qualities of useful information.

- The qualitative characteristics of accounting that are most important to the needs of financial analysts are relevance, reliability, both verifiability and representational faithfulness, timeliness and neutrality. Analysts need to know economic reality—what is really going on—to the greatest extent it can be depicted by accounting numbers. Information must be relevant to the process of analysis, one reason why much space earlier was devoted to describing the analyst's work **[p. 1]**

- Information often is not available in distressed situations. If the accounting reports were more standardized with some more information that's pertinent to creditors and investors, analysts would not have to go through the process of trying to solicit information that management won't provide to them **[p. 3]**

- The sell-side analysts demand the most complete, objective information; the buy-side analysts and portfolio managers are only slightly less demanding, followed by the institutional sales brokers and the retail brokers. Brokers, however, rely heavily on the work of the sell-side analysts; their recommendations are thus based on high-quality information and analyses, even though they usually do not analyze the data themselves **[section 1(a), p. 2]**.

Financial analysts desire information that is both relevant and reliable, but they often prefer information that is exact or certain but of limited relevance over information that is inexact or uncertain but relevant. Further, they sometimes prefer information that is inexact or uncertain but relevant over information that is exact or certain but of limited relevance. That ambivalence regarding relevance and reliability also is reflected in later subcategories of this category, such as those on reliability, neutrality, and conservatism (section 2(b)), and in other parts of the database, particularly those concerning value information (section 4), display in financial statements (section 5), and measurement uncertainties (section 9).

- In an ideal world, the most relevant accounting data would be those that reported assets and liabilities in a way that would allow analysts to impute the future cash

flows emanating from them individually and collectively. The certainty embodied in that world does not exist, and analysts need to strive for an accounting model that reflects the degree of uncertainty that besets a particular enterprise. The result necessarily is an eclectic valuation system, one in which cash expected to be received from assets and market and other current values of assets are used to the extent possible and historical cost is reserved for assets whose current value can as yet not be determined or estimated reasonably **[p. 1-2; section 4, p. 4]**

- Most investors, expecially the professionals and the semiprofessional individual investors, think that they can spot biases; some believe that they can filter out the biases to reach some degree of objectivity. If they cannot eliminate the biases for themselves, they place high value on information sources that can do so, either analytically or based on experienced judgment **[section 1(b), p. 15]**

- Almost half of the approximately one hundred investment institutions and bank lending officers in a survey disagreed that sometimes it was necessary to sacrifice relevance or reliability to gain the other, but about ten of eleven surveyed would choose to sacrifice relevance to gain reliability, rather than vice versa, if the choice had to be made **[p. 8-9]**

- Historical costs are sunk costs and there is little disagreement that they are often irrelevant to financial decisions, but there is considerable debate about whether they should be totally replaced by more relevant current values

  - There is some opinion among analysts that determining the current values of specific assets is a function of financial analysis, not financial reporting. Even among analysts not holding that view, a majority would not welcome an imminent change to "mark-to-market" accounting. They would not be happy to see historical costs removed from financial statements because they are not convinced that it would result in an increase in relevance sufficient to offset the reduction in reliability of the new data **[p. 2, section 4, p. 4]**

  - Some analysts support mark-to-market accounting wholeheartedly, believing that it should supplant historical cost in financial statements. More analysts support market value accounting for investments in marketable equity securities and financial instruments but not for tangible or other intangible assets or perhaps not for financial institutions **[p. 2, section 4, p. 4]**.

2(b). Reliability and neutrality, including conservatism and volatility

Note: This subcategory of the database contains at least five leading views on four subjects: (A) credibility problems, (B) reliability, neutrality, and credibility of reporting, (C) reliability, neutrality, and conservatism, and (D) volatility, representational faithfulness, and smoothing of reported results. Alternative views are identifiable for some of the five.

<u>Leading view</u>

Credibility of reporting is a serious problem. Investors, creditors, and their advisors believe that many companies' managements are not forthright in reporting problems and poor company performance, that much of the information they disseminate is too "promotional," and that troubled companies take great pains to convey the impression that they are not seriously troubled. They do not believe that management habitually tells outright lies in its reporting, 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. Investors, creditors, and their advisors believe, for example, that management emphasizes nonrecurring losses while burying nonrecurring gains in continuing earnings. They also believe that management tends to double-up when it has to report bad news by also recognizing other losses that have occurred earlier whose recognition has been deferred and/or losses whose current recognition will avoid the need to recognize expenses or losses in the future.

- Investors, creditors, and analysts often distrust what companies tell them in their annual reports. Most professionals doubt that many company managements are forthright in reporting problems and poor company performance **[p. 2, 8]**. Users believe that managements tend to disclose their company's performance in a manner that is most favorable to the company and therefore may not indicate actual results **[section 1(a), p. 1-2, 12]**

- Professional investors and analysts believe that corporate managers naturally tend to disclose their company's performance in the most favorable light. Although they have confidence in management integrity, they say that managers commonly procrastinate in disclosing problems and that many managers express a more optimistic view of their company's situation than seems warranted by the professional's own analysis **[section 1(a), p. 1]**

- Investors, creditors, and their advisors have found that companies resist disclosing information about liabilities, contingencies, and other disagreeable things and events on grounds of competitive information content. Many who hear that explanation doubt that disclosure of so-called sensitive information is anywhere nearly as sig-

nificant an issue as the companies would like to make it sound and think that the companies hide behind it **[section 2(d), p. 12; section 1(b), p. 70, 74, 76-78]**

- Investors, creditors, and their advisors doubt that annual reports candidly discuss bad news and problems, and what management is doing to solve them, and think that annual reports often play down bad news or hide it in the back of the report. In general, bad news is disguised, and good news is overplayed. Too often, the blame for mistakes is placed outside the company, and management won't take responsibility **[p. 2-3]**

- Comments showed a growing frustration with managements' lack of candor and insight into the numerous problems of both the life and property-casualty companies. It is hard to believe, but the quality of the industry's reporting to shareholders continues to deteriorate **[p. 4-5]**

- While very few investors doubt the integrity of corporate management, most believe that corporate reporting is not objective, that it is consciously or unconsciously slanted to show the company in its best light, by, for example, delaying the reporting of negative information in the expectation, or perhaps hope, that the situation will soon be corrected. Or they believe that management is simply so involved with the company that it reports biased information without realizing it. That perception makes "objectivity" one of the components of the value of investment information. Questionable credibility is one reason that both individual and professional investors use so many different sources of information **[p. 3]**

- What really shakes the confidence of the user community is the propensity to have a series of surprise adjustments or write-offs. And it always seems to group itself around periods of economic stress **[section 2(c), p. 16; section 17(a), p. 14]**. Frequent write-downs of assets and reoccurring restructuring charges have led users to believe that companies' asset values have been overstated in the past **[section 17(a), p. 13; section 1(a), p. 50, 59]**, resulting in loss of confidence in the accuracy and reliability of values that are reported currently **[section 17(a), p. 13, 14]**

- That companies take the opportunity to recognize restructuring charges and write-off assets when they realize a large gain shows that management is often shortsighted and unreliable. Analysts can't believe what management tells them many times **[p. 7]**

- Professionals' skepticism focuses mostly on the qualitative aspects of corporate information, expecially on corporate disclosures and explanations of problems and poor performance. They have greater confidence in "the numbers," but even that feeling is tempered by knowledge that, despite financial reporting standards established by bodies such as the SEC, the FASB, and various industry regulators,

corporate management still has great latitude in its selection of accounting rules, interpretations, cost and revenue allocation, and the like **[section 1(a), p. 1]**. Much of the credibility question is focused primarily on the front half of the annual report, the narrative part, which is subject to less rigorous scrutiny by regulators and auditors and offers wide latitude to management on inclusion or exclusion and reporting of information **[p. 2]**.

Credibility of accounting information rests on its reliability and neutrality. Users can depend on the information to represent faithfully the economic things or events that it purports to represent without bias intended to attain a predetermined result or to induce a particular mode of behavior.

- To be useful, financial statements must be trustworthy. Two primary characteristics make them reliable—representational faithfulness, which refers to the likelihood that an accounting measure depicts accurately the nature of the object being measured, and verifiability, which refers to the likelihood that different accountants looking at the same evidence will draw similar conclusions. They also must be neutral, providing information that is without bias. Investors both buy and sell securities. Creditors extend credit to those who need time to pay and lend to those who need funds. Financial statements should inform both sides of a transaction in a way that neither is favored **[p. 5]**

- Virtually all investors want unbiased, candid, unembellished investment information. They do not want sales pitches from brokers, optimistic expectations (or self-serving excuses) from company management, or information distorted by inappropriate interpretation and analysis **[section 1(b), p. 15]**

- Users wholeheartedly support the precept that standards setters ensure, insofar as possible, the neutrality of information resulting from accounting standards. Any other approach would render financial statements useless to investors and creditors as well as to the economy and society at large **[p. 34]**

- Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions but should not try to determine or influence the outcomes of those decisions. The role of financial reporting requires it to provide evenhanded, neutral, or unbiased information **[p. 34]**

- An investor in securities is confronted with an array of securities which he or she may buy, hold or sell, or decline to buy. If, through some misperception of conservatism, either in the reporting and valuation or in some kind of smoothing of earnings, the investor doesn't get a true picture of what the company operations are, the financial statements haven't fulfilled their obligation **[p. 18]**

- While all information affected by judgments necessarily has some bias, there should be no purposeful bias favoring any group. Absence of bias, which may be characterized as neutrality and fairness, has long been recognized in accounting **[p. 34-35]**

- Professionals have high praise for companies whose executives completely and candidly disclose their performance; in fact many regard that disclosure as an indicator of the competence and self-confidence of the management group **[section 1(a), p. 1]**. To all types of investors, the credibility of an annual report, or any other information source, depends on the degree to which it is correct, complete, and objective [reliable (representationally faithful and verifiable) and neutral, in the words of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*] **[p. 2]**

- Despite some short-term discomfort, full disclosure actually enhances management credibility in most cases, and earnings quality sometimes seems to be related to "representational faithfulness" and management's forthrightness in disclosure. The few companies whose annual reports are considered to be highly credible (Berkshire Hathaway and Quaker Oats are frequently-cited examples) earn high marks and expressions of great respect from professional investors **[p. 3-4]**.

Many users of accounting information are somewhat ambivalent about its reliability and neutrality and are willing to give up some representational faithfulness and neutrality, as well as some relevance, to gain "objectivity," the continuity of a "benchmark," and the comforting bias of a little conservatism. If they see information as having more objectivity and continuity, they tend to be relatively less concerned with the lack of reliability of allocations of costs and revenues.

- Many investors, creditors, and their advisors rely on historical cost because of consistency and the relative objectivity **[p. 17]**

- Many use historical financial statements as a benchmark that is helpful in making forecasts of future performance. They need to be confident that the benchmark used stays the same, and historical financial statements provide that sort of stable reference point. The historical statements show how management allocated assets and the subsequent outcome of those decisions; which provides some guidance on the future **[section 4, p. 13]**

- Current practice, which is largely based on historical costs, provides a stable benchmark from one reporting period to the next, which analysts need to forecast future performance **[section 4, p. 51, 84]**

- What analysts want from the financial statements of a company is a record of the financial effects of actual economic events, and in the simplest terms. In a complex world some adjustments of such simple reports are necessary, but there must be a very good reason to step away from that record of actual historical transactions. That's the continuity, the benchmark that analysts look for in the statements as they now exist, which are predominantly historical cost **[section 4, p. 86-87].**

The most widely expressed view was that conservatism means that the uncertainties that inevitably surround many transactions should be recognized by exercising prudence in preparing financial statements but does not justify creation of secret or hidden reserves.

- Conservatism should not connote deliberate understatement of assets or overstatement of liabilities. Nor should financial reporting attempt consistent understatement of income, which in any event is impossible to achieve because decreasing income of one period inevitably increases income of a later period or periods **[p. 12-13]**

- Conservatism is a prudent reaction to uncertainty to try to insure that uncertainties and risks inherent in business situations are adequately considered. For example, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism suggests using the less optimistic estimate. However, if two amounts are not equally likely, conservatism does not dictate using the more pessimistic amount rather than the more likely one. Neither does it require deferring recognition of income beyond the time that adequate evidence of its existence becomes available nor justify recognizing losses before there is adequate evidence that they have been incurred **[p. 13, 24]**

- Almost all analysts would agree that so-called lower of cost and market methods are neither informative nor useful because they are based on the untenable premise that market value is a good accounting measure when it is lower than historical cost but not when it is higher. The best argument that can be made in favor of lower of cost and market is that it reveals market values when they are lower than cost, thus divulging important information on some asset impairments **[section 2(a), p. 2]**

- To question the reliability of some fair values is fine and good, but the fact is that the present historical book value that is recorded is significantly less reliable than someone's best guess of fair value today in 95% of the cases. For example, Rockefeller Center gets an appraisal every year and recently was appraised at $1.6 billion. Meanwhile, the bond is trading as if it's worth maybe $700 million. The best guess of what it's worth today is valuable to have relative to what it cost in 1936 **[p. 9]**

- Many financial analysts really like to see a company where they can take a straight edge and describe the trend in earnings, which invites manipulation to which conservatism may contribute. Conservatism sounds like a nice thing, but the more

conservative a company is, the more leeway it has to manipulate the trend. Analysts should be wary when accountants put in a change in accounting principles that appears to be more conservative because it might just give more room to manipulate the trend. Conservatism is a way of boosting future reported earnings **[p. 11-12]**

- If everyone agrees that a certain outcome is most likely—it's the best guess—but there is a more conservative outcome that is at least reasonably possible but not the best guess, financial statements should report the best guess without bias whether it's conservative or liberal. But if the likelihood is 50/50, the conservative estimate should be reported **[p. 11-12]**

- Conservatism is something that a creditor would always like to see. Quite often, management will say that their numbers are conservatively stated, and creditors will be much more liberal in applying underwriting standards to a company that did consistently conservative reporting. Conservatism should mean prudence in evaluating uncertain outcomes and amounts, not creation of secret reserves **[p. 19-20]**

- Companies should not ignore reality in the interest of conservatism. All analysts have seen companies that decide they will grow 16% rather than 20% this year and sock earnings away in reserves for future years. If they learn about it, analysts will go back and make adjustments because they want unbiased information. Similarly, analysts want to know if things are horrible **[p. 12]**.

Another widely-expressed view was that conservatism makes it likely that possible errors in measurement will be in the direction of understatement rather than overstatement of net income and net assets, and future surprises thus are likely to be pleasant. The emphasis still is on prudence, but with more tolerance for hidden reserves, properly used, than the other leading view. To hold back something for a rainy day to avoid the need for an unpleasant surprise generally is acceptable, even laudable, while to use unspecified and unfathomable reserves, selective conservatism, or both to smooth reported earnings is game-playing that not only reduces the quality of earnings but also stains management's credibility.

- There are two ways of looking at quality of earnings. One is the conservatism aspect; for example, a company using accelerated depreciation using the same useful lives as another company using straight-line, is clearly more conservative and is perceived as having better quality of earnings. The second aspect is predictability and stability **[p. 15]**

- To many equity sell-side analysts, a company with high earnings quality is one that uses highly conservative accounting principles; for instance a company that has accrued reserves against future losses, write-downs, etc. For example, an analyst reported earnings quality as high for a firm with an "aggressive" policy towards

establishing reserves, another substantiated an assertion of high earnings quality by saying that "the company is over-accruing foreign taxes as a way of managing earnings," a third supported its assertion of high quality earnings by noting that "the opportunity to 'manage down' earnings exists," and a fourth argued that a financial company's earnings were more "credible" because the company applied "more aggressive accounting" methods in writing down assets, all of which suggests a possible preference by many analysts for secret reserves **[section 5(a), p. 3, 4]**

- A lot of the write-offs of assets and accruals of reserves that are done are more to justify a bad year; dumping everything the company possibly can into that year so its reported earnings will improve next year **[p. 19]**

- If companies are setting up reserves, analysts would like to see when and how the reserves are used—to have a stream of information as the assets are written off about what part of the reserves has been applied against those assets. They see higher quality of earnings if a company breaks out the reserves from the general accruals category because otherwise analysts have no way of knowing what is in the reserves and how they are applied to specific assets **[section 5(b), p. 3]**

- In an environment in which an increasing number of companies are taking significant noncash charges for "restructuring," the extent to which, and when over a period of time, those dollars are going to be spent either to lay off people or to physically close plants, analysts need to be able to get some sense of how and when the cash reserved by restructuring charge has been used. It goes back to when and how the reserve account is relieved **[section 5(b), p, 4]**

- LDC loan-loss reserves were used to smooth reported earnings and hide the cash effects. Some large banks set aside billions of dollars and later flowed back as much as a third of it into the income statement **[section 5(c), p. 11]**.

Companies whose businesses are volatile should faithfully report that volatility and should not smooth earnings to appear less volatile than the underlying business.

- Stable results tend to lower cost of capital, providing an incentive to try to report stable results to lower cost of capital. The tendency is always in that direction, but investors need to be apprised of the true volatility to make correct credit judgments in allocating capital, and it's important that the financial statements reflect the underlying reality **[p. 22]**

- Companies that report significant swings in earnings are more difficult to analyze. But if that is the nature of their business or industry and thus a risk that needs to be understood, an analyst wants to know that fact and not have it buried in an accounting treatment **[p. 31]**

- Accruals and deferrals are necessary for proper accounting for assets, liabilities, earnings, etc., but they often require allocations and estimates of future transactions. Care must be taken to see that their use not be extended to permit "normalization" of earnings between periods. Normalization, like forecasts and projections, is the province of financial analysis and should not be incorporated into financial reporting **[p. 1]**

- Investors pay a premium for stability because it is presumed to be an indicator of lower future risk and uncertainty and thus should get a higher valuation, but the market has gotten a little more sophisticated in viewing stability, giving low multiples for more diversified businesses versus less diversified businesses. An analyst can understand whether reported volatility is reality much more easily in a one-product business or one-industry business, like Coca-Cola, than in a highly diversified company. Many large diversified companies have broken up, cognizant of the fact that the market penalizes companies if investors and analysts can't understand how the trend in earnings comes about. Just showing a nice trend that investors don't believe represents reality will not provide a value as high as about 10 years ago **[p. 13-14]**

- Stability enhances predictability. If investors believe a company can report earnings of at least so much in the next year, it's worth more than if they have no idea **[p. 15]**

- Earnings volatility has little or nothing to do with earnings quality if the investor or analyst knows that the company is following good accounting procedures **[p. 14]**.

<u>*Alternative view*</u>

Conservatism is a doctrine that serves users of financial statements well and should be observed consistently by financial statement preparers.

- In dealing with estimates, there may be no such thing as neutrality. It's good in principle, but, in fact, in making estimates one must be subjective and can't be neutral. A useful bias is that if you have to err, err on the side of conservatism because it does less harm **[p. 11]**

- Conservatism is difficult to define, but its spirit is found in these two statements: (1) "Recognize all losses when they occur, but do not recognize gains until they are realized" and (2) "If in doubt, err on the side of undervaluing assets and overvaluing liabilities." Conservatism is, of course, antithetical to the notion that accounting should be even-handed and free from bias—neutral **[p. 1-2]**.

Smoothing or normalization sometimes is useful in minimizing volatility from or quieting "noise" in reported earnings by removing the distracting effects of interim fluctuations in the assets that happen to be held at the moment.

- For example, pension accounting includes a kind of a compromise that permits companies to smooth the effects of changes in market values of assets in the pension fund and to spread the effects of changes in actuarial assumptions to eliminate or minimize volatility **[p. 8]**

- That aspect of pension accounting reflects the realities of the world and to that extent it's good. The real question is whether or not the actuarial assumptions are valid. They have been subject to some abuses **[p. 8-9]**

- Accounting is not in the business of putting businesses out of business. In some instances, an inability to spread gains or losses to minimize volatility would really create a problem **[p. 8]**.

2(c). Comparability, excluding alternative accounting procedures

Leading view

Financial analysis for both investment and credit decisions relies on comparisons, and the quality of comparisons is elevated to the extent that financial accounting standards produce financial statements that are consistent from period to period and comparable from company to company.

- Comparability and consistency in financial reporting over a long time, generally 5 to 10 years, is very important in comparing an enterprise's performance and financial position within its industry and across industry lines. Interfirm comparability in reporting allows comparison between and among different companies (cross-sectional analysis). Interperiod consistency in reporting allows comparison of data from one reporting period to the next for a single company (time series analysis). Internal consistency allows comparison of one financial statement item to another (financial ratio analysis) **[p. 1]**

- Financial statements that are consistent from period to period and comparable from company to company is a goal to be coveted and worked toward but never totally attained because of differences between companies and the need for new accounting standards **[p. 2]**

- For financial analysis, priority should be given to providing financial information that reflects and reports sensibly the operations of specific enterprises. If analysts could obtain reports showing the details of how an individual business firm is

organized and managed, they could take more responsibility for making meaningful comparisons of those data with the unlike data of other companies that conduct their business differently. To mandate a disclosure standard while maintaining the flexibility of each enterprise to report its own circumstances and organization would be extraordinarily difficult, but would be a commendable undertaking **[p. 3]**

- Financial analysis can handle differences between companies, even in the same business, if analysts can obtain information that enables them to understand the differences and interpret them as clearly as possible. Differences in accounting should be allowed as long as there is disclosure **[p. 8]**, which are subjects considered more fully in **section 8**–Alternative Accounting Procedures.

Many investors, creditors, and analysts value information that is consistent over time more highly than information that is comparable between companies because they consider themselves capable of adjusting information to compensate for noncomparabilities resulting from use of alternative accounting procedures and many differences in companies but they usually are unable themselves to fill gaps in information resulting from business combinations accounted for by the purchase method, changes in accounting procedures, and the like.

- Financial analysts generally do not rely on a single year's results to make their decisions, typically gathering historical data for five, ten, or even twenty years and analyzing trends and relationships in the information **[p. 21]**

- A change in accounting principles destroys the comparability of data before and after the change. Even if standards setters require restatement, analysts obtain only three comparable income statements and two comparable balance sheets. Analysts sometimes have sufficient information to estimate the effect of the change on earlier years and are able to restate the results themselves, and some companies take the time to assist analysts to understand the pre- and post-change data. Generally, however, the ability to analyze trends over a long period is simply destroyed **[p. 22]**

- Significant costs to users attach to new accounting standards that do not preserve the consistency and comparability of financial reports, and the diversity of approaches taken to the effective date and transition provisions for new standards has created major problems of comparability and consistency for users of financial statements

  - Particularly destructive of consistency and comparability are effective date and transition provisions that permit the standard to be adopted in any of several years and allow a choice of how to adopt, such as, retroactive application, prospective application, application to a single year with "catchup adjustment," and the like **[p. 21]**

- For standard setters to issue fewer pronouncements is an unacceptable solution, but they should consider simplifying the procedure for adopting new pronouncements by making them effective for everyone in a single year and prescribing only one method of adoption [p. 21]

- Overall, standards setters have done more to improve the usefulness of financial reporting by focusing on relevance and reliability than they have to improve comparability and consistency [p. 21]

- Accounting standards may lead to financial data being destroyed without commensurate improvement in the financial information provided

  - New accounting standards often are needed, and standards setters' prompt action is expected if existing generally accepted accounting principles are inadequate or misleading, but the destruction of financial data is a cost to users of financial statements that standards setters should consider in decisions about a new standard [p. 22]

  - Unless a new standard produces significantly better information (more relevant and more reliable), it should not be implemented [p. 22]

  - Many analysts believe that at least three standards adopted within the past few years do not meet the criterion that new standards should not be issued unless they provide significantly better information: FASB Statements No. 94 (Consolidations), No. 96 (Deferred Taxes), and No. 97 (Insurance Company Reporting). Problems caused by Statement 94 should be remedied by FASB's project on disaggregated information, but analysts complain that the information gap has been left open much too long [p. 22]

  - Comparability of accounting numbers is not universally good. The decision made in the interest of comparability that nonfinancial companies must consolidate their finance subsidiaries has reduced the amount of information available [section 8(a), p. 1]

  - Investors need consolidating financial statements if a financial subsidiary of a non-finance entity has been consolidated in accordance with FASB Statement 94 [section 3(c), p. 12].

<u>Alternative view</u>

A major objective of financial accounting standards should be to eliminate (or, at least, reduce) the use of alternative accounting methods under similar circumstances, which contributes to a loss of comparability and thus reduces a financial statement user's ability to judge relative risks.

- This is a minority view, which is considered more fully in **section 8**–Alternative Accounting Procedures.

3. Disaggregated Information

3(a). Compliance and criticisms of Statement 14

Leading view

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.

- Statement 14 broadly defines "segments" and, therefore, results in the disclosure requirements of this pronouncement being applied inconsistently in practice [p. 2]. Most entities do not provide disclosures that comply with the spirit of the pronouncement [p. 5, 7]

- Financial statement preparers have used the flexibility allowed by Statement 14 in determining reportable segments to limit their disclosures to vague information that is not helpful to users in predicting an entity's future earnings or cash flows [p. 1, 6]. Entities have limited disclosure of disaggregated information because it is considered to be competitively harmful [p.5, 10]

- Some entities disclose in their footnotes that they operate predominantly in one industry but will discuss their operations with users as if they were in more than one business [p. 6]

- Statement 14 limits entities in providing useful disclosures by not allowing them to report their businesses in the manner in which they are organized and managed [p. 1-4, 7-9, 11]. Some entities do not internally report or monitor segment information in a manner that meets the disclosure requirements of Statement 14 [p. 9].

3(b). Basis of disaggregation

Leading view

At a minimum, users need disaggregated information on an industry basis and, in certain instances, a geographic and line of business basis. In those circumstances in which the company is not managed on an industry basis, users would prefer that disaggregated information be presented in a manner that is consistent with the way the entity is managed.

- Users have a preference for disclosure of disaggregated information by industry segment, management responsibility, and individual product or product group within an industry **[p. 20-21, 24-25]**

- Multinational entities should provide disaggregation by geographic location **[section 3(c), p. 1]**

- When presenting disaggregated information by geographic area, users have a need for information based on the location where the products or services are produced as well as information based on where they are delivered or used **[p. 21, 25, 29]**

- An entity should disclose its segment data in a manner that bears resemblance to the industry in which the segment is competing **[p. 3]**

- Segmented financial and operating data are appropriate both by lines of business and geographic area **[p. 27]**

- Disaggregating financial information by management responsibility would facilitate users' understanding of the entity's operations **[p. 4]**. Understanding how a multi-dimensional entity operates is an important element in users' estimating future earnings and cash flows of the entity **[p. 1-2]**

- Disaggregated information should be presented in a manner that is consistent with the way the company views itself and reports internally **[p. 4, 6, 15, 18, 27]**. This form of disclosure would provide users with another method of evaluating how the business is managed **[p. 28]**.

User believe that segments of the entity's business that have significantly different opportunities and risks should be disaggregated and disclosed separately in the financial statements.

- Disaggregated information should be presented in sufficient detail to allow users to identify the various levels of risks that are embodied in the entity **[p. 1]**

- Disaggregated information should be present in a format that discloses the source and nature of opportunities and risks that are expected to affect the amounts and timing of the entity's future cash flows **[p. 2, 4, 7-8, 14]**

- To the extent that products do not have similar opportunities and risks, they should be disaggregated and separately disclosed **[p. 4, 8, 13, 19]**

- An entity may have various levels of opportunities and risks based on the locations of its operations and its principal markets **[p. 8-9, 15, 21, 24-25, 29]**.

Some users, in particular creditors, also need disaggregated financial information on a legal entity basis.

- Consolidating financial statements on a legal entity basis provide creditors with a better understanding of the borrowing unit and helps them assess the cash flows available to repay the obligation **[p. 16-18, 20]**.

3(c). Types of disaggregated information disclosed

Leading view

Users need disaggregated financial information for each reported segment to a greater degree than is now disclosed. The following disclosures should be made at a minimum:

- *revenue* **[p. 6, 9, 10, 13, 13]**
- *gross profit* **[p. 9, 10]**
- *operating profit* **[p. 6, 7, 9, 10, 13]**
- *total assets* **[p. 6, 9, 11]**
- *total liabilities* **[p. 6, 11]**
- *cash flows from operations* **[p. 1, 2, 9, 11]**.

- Disaggregation of a multifaceted entity provides users with information that is helpful in estimating the future cash flows of the entire entity **[p. 3]**

- Disaggregating the entity's operating results below the operating profit level may not be meaningful because it would involve a discretionary allocation of corporate overhead costs **[p, 7, 8]**.

3(d). Frequency of segment reporting

Leading view

Users need quarterly disclosure of disaggregated information.

- Users are in favor of mandating quarterly segment reporting because it would increase the value of quarterly financial information **[p. 1, 3, 4]**. However, users have mixed views on the type of disaggregated information that should be presented quarterly. Some believe that disaggregated disclosures should be made at the same level of detail required in annual financial statements **[p. 4-5, 7-8, 10]**, while others believe that interim disaggregated disclosures should be an abbreviated version of what is required annually **[p. 8, 10]**

- Quarterly disaggregation of an entity's financial statements would assist users in evaluating an entity's performance on a more timely basis and would reduce year end surprises of unusual matters **[p. 1, 4, 7-8]**

- In most cases, disaggregated information is available to management on at least a quarterly basis and, therefore, should be disclosed in the entity's quarterly financial statements for user consideration **[p. 4-5, 7]**.

3(e). Other

Leading view

Users need consistency within an entity's segment reporting and, in that regard, believe that segment information should be restated for a period of five to ten years when the entity changes its reportable segments **[p. 4-5]**.

Creditors prefer segment reporting requirements to be the same for public and nonpublic entities **[p. 6-8]**. *Creditors also prefer comparability in segment reporting* **[section 3(b), p. 23]**.

Alternative view

Creditors would not require nonpublic entities to disaggregate their financial information for external reporting purposes **[p. 6-8]**.

4. Value Information

Leading view

Users do not favor replacing the current historical-cost-based accounting model to a market value accounting model. They would retain the current mix of measurement attributes used under the existing model.

- Users want to retain the current historical-cost-based accounting model because:

  - The current historical-cost-based model provides users with a stable and consistent benchmark **[p. 3, 8, 13, 22, 34, 38, 42, 51, 71, 84-85, 87, 100, 128]** which they can rely upon to establish historical trends **[p. 8, 31, 42, 51, 66-67, 122]**

  - Although a mixed attribute model, it is predominantly a transaction-based model and, therefore, most of the reported values are reliable **[p. 1, 5, 11, 87-88, 120-121, 125-126]**.

- Users oppose a market value accounting model because:

  - Estimates of fair or market value may be subjectively determined by management **[p. 13, 17, 23-25, 27, 43, 51, 61-62, 66-68, 70, 74-75, 82, 92, 112, 117]** or based on thin markets or models of hypothetical markets and, thus, they lack sufficient reliability to replace historical costs **[p. 1-2, 4, 11, 14, 23-24, 27, 34, 37, 43, 51, 70-71, 120, 124]**

  - Fair or market values would introduce an unacceptable level of volatility or noise in the income statement and/or in stockholders' equity which is not useful to users in assessing a company's future performance and prospects **[p. 7-9, 11-12, 16, 29, 34, 43, 51, 65-66, 70-71, 75, 84-86, 97, 121-122, 142-143]**

  - There is a lack of agreement on the appropriate definition of fair or market value, adding to the subjectivity of value information and reflecting different uses of value information **[p. 13, 24, 30, 61, 87-88, 95-98, 100, 111]**. Creditors are generally interested in liquidation values (perhaps in distress situations) **[p. 33-35, 83, 108-109, 111]** while investors are more interested in going concern values **[p. 12, 51, 61, 75, 86]**

  - A market value accounting model does not reflect the nature of the ongoing business of an entity (this point was particularly made in the context of financial institutions) **[p. 38, 60, 67-68, 71, 73-75, 85-87]**. It could potentially lead to a

negative change in management's economic behavior [p. 61-62, 67, 71, 81-82, 112, 144]

- It is not the purpose of the balance sheet to provide an estimate of a company's economic or market worth [p. 10, 57]

- Timeliness is a problem; the information would be stale by the time it is released [p. 5, 38, 43, 52, 64, 71, 76-77]

- Users are not convinced that the cost of determining the fair value where market value is not readily available is justified by the benefits [p. 7, 41, 43, 68, 91, 93, 132, 141]

- It is the analyst's job to estimate value rather than management's job [p. 10, 14, 19, 22, 84, 115]. Analysts believe accountants should provide consistent, objective information which analysts can use in conjunction with fair values, if appropriate [p. 10, 14, 19, 21, 22, 44, 84, 115]. There also is an implicit lack of trust in management in the area of value information [p. 23, 43, 51, 90, 101, 112, 115, 130]. Users believe that it would be preferable to provide more information about the characteristics of assets and liabilities in external reports so that they can make their own assessment of value [p. 37, 62, 76, 80, 92-94].

Fair or market values, if disclosed, should be in the notes to the financial statements or in accompanying schedules. Detailed assumptions underlying the estimates should also be a required part of the disclosure in order to permit the user to adjust the disclosed amounts.

- Fair or market value information is useful when combined with and compared to historical cost information [p. 1-5, 10-11, 16, 19, 22, 24, 33, 35-36, 44, 50, 61-62, 66-71, 73-75, 81-82, 90, 92-93, 101, 104, 121-122, 125, 127, 129, 138-140, 143, 145]

- Users are willing to accept less reliability in the context of supplementary disclosures than in the context of measurement in the balance sheet or the income statement [p. 78-79]

- Some users would prefer that the information be included in the notes to the financial statements or be audited [p. 39, 65] while others do not attach much importance to the location of the information or to the need for it to be audited [p. 39-40, 65]

- Users need to know the assumptions underlying the fair or market values disclosed in order to make their own assessment as to the validity of the disclosures and

consistency of the basis of determination period-to-period **[p. 37, 62, 70, 80, 93-94, 112-113]**

- Fair values are not necessarily market values in all cases because of the size of the asset/liability, the business component in which it resides, and inefficiencies in the market that inconsistently impound future expectations in the current valuation **[p. 20, 23, 30, 37-38, 43, 58-59, 86, 94, 96-98, 112]**.

Users view fair value disclosures, as opposed to measurements, as useful for particular types of assets and liabilities and in certain types of industries.

- Users are interested in the fair value of certain assets. Users would not replace historical cost with a fair value creating a gain prior to completing a transaction because of skepticism of management's estimate, but knowing management's expectations and assumptions is useful **[p. 17, 21, 36, 46, 103, 109, 128]**. Some of the types of assets and liabilities mentioned include:

    - Non-operating assets **[p. 21, 46, 53, 120, 128, 136]**

    - Financial assets **[p. 6, 13, 16, 21, 46, 53, 76, 83]**

    - Assets and liabilities intended to be sold, settled, or disposed of, as opposed to being part of the ongoing business **[p. 26, 46, 53, 104, 128, 131]**

    - Assets for which market prices from active secondary markets are available **[p. 46, 53]**

- Users view fair value as conceptually more applicable to financial industry activities than manufacturing activities, although they question fair value disclosures that fail to reflect "matching" of financial assets and liabilities **[p. 5, 7, 13]**

- Users do not view fair value reporting as a useful means of adjusting accounting information for inflation; instead, many use price-volume analyses **[p. 14, 40, 48, 49]**.

<u>*Alternative view*</u>

More market or fair value measurements should be included in the body of financial statements in certain limited circumstances. In other words, users would favor including more fair value measurements in the current mix of measurement attributes under the existing model.

- Some of the circumstances most often mentioned are:

    - For non-operating assets [p. 21, 46, 53, 120, 128, 136]

    - For financial assets [p. 6, 13, 16, 21, 46, 53, 76, 83]

    - For assets and liabilities intended to be sold, settled, or disposed of, as opposed to being part of the ongoing business [p. 26, 46, 53, 104, 128, 131]

    - For liquidating or distressed companies [p. 47, 54, 74]

    - For assets for which market prices from active secondary markets are available [p. 46, 53]

- Users believe that in some circumstances, the increase in relevance of fair value measurements compensates for their relatively lower reliability [p. 4, 21, 83, 120, 128, 131] or, in the case of assets for which market prices are readily available, that their reliability is adequate [p. 6, 16]

- Some users believe that the changes in fair or market values arising from the suggested measurements should be recognized in the income statement [p. 123] while others would prefer to avoid the income volatility and recognize the changes directly in stockholders' equity [p. 14]; presentation of the changes in comprehensive income was also suggested [p. 9].

5. Display

5(a). Income statement, including core earnings and comprehensive income

Leading view

Core Earnings:

Most users following the fundamental approach need information about the portion of a company's reported earnings that are stable or recurring and that provide a basis for estimating its expected repeatable normal earnings over a span of future years (core earnings).

- Although core earnings are difficult to define (and users don't want accountants to do so) and may exclude or include certain items depending on the user's view, users develop such earnings **[p, 1-3, 7-9, 11, 13-14, 19, 23, 29, 34-35, 40-41]**

- Users consider the development of core earnings as a concept of financial analysis and not necessarily of financial reporting **[p. 34-35]**

- Users rarely compute core earnings directly; rather they adjust net income. Users usually adjust reported net income for all or some of the following:

  (a) nonrecurring, unusual, and infrequent items in reported revenues, expenses, gains and losses **[p. 1, 3, 6, 8, 13, 22]**
  (b) tax expense **[p. 14]**
  (c) interest expense **[p. 26]**
  (d) extraordinary items **[p. 8]**
  (e) discontinued operations **[p. 2]**
  (f) accounting changes **[p. 2]**
  (g) noncash charges such as depreciation and amortization **[p. 26]**

- In general, financial statements already separately display items (b) through (f). Further, the statements and notes generally include sufficient information about those items to permit users to compute core earnings

- In contrast, financial reporting does not contain sufficient information about nonrecurring, unusual and infrequent items to meet users' needs in computing core earnings. The information is insufficient because (1) the statements do not identify a sufficiently broad range of potential nonrecurring, unusual, and infrequent items and (2) the descriptions and details of items labeled as nonrecurring, unusual and

infrequent are sometimes insufficient to permit users to evaluate for themselves whether those items are part of core earnings **[p. 22-23, 27]**

- Users also review operating income to determine whether it contains items that are not judged to be part of normal operations **[p. 3]**. As an example, they want to know that a very material new customer has been secured which will result in a dramatic increase in sales **[p. 12]**.

Despite wanting to compute or recompute core earnings for themselves, users would not object to separate display of a caption titled core earnings, provided that the statements also include sufficient information about nonrecurring, unusual, and infrequent items.

- The disclosures would include the description and amount of potential nonrecurring, unusual, and infrequent items that are close calls for either inclusion or exclusion in core earnings **[p. 3]**.

Regardless of whether a separate caption titled core earnings is displayed on the income statement, users need improved information about nonrecurring, unusual, and infrequent items including close calls.

- The financial statements and notes should separately describe the type and amount of those potential items in sufficient detail to permit users to reach an informed opinion about whether those items are part of core earnings **[p. 1, 3, 11-12, 26, 30-31]**

- Users find acceptable either management determination of nonrecurring, unusual and infrequent items subject to auditor verification (although credit users are not confident of management's ability to make the determination) or the establishment of special criteria on which to base the determination with a slight preference for the establishment of special criteria **[p. 24, 26, 40]**.

<u>*Display that improves users' understanding of the business:*</u>

Users would find helpful improvements in the display of information on the income statement that would assist with their analysis of the business.

- Users have stressed the importance of understanding as much as possible about the businesses of the companies that they consider and the close linkage between the financial statements and actual events. The current form of display already provide useful information about the company's business and actual events. For example, revenue is reported apart from expense and certain types of expenses are separately reported. That display enables analysis of trends and relationships that could not be

done if those items were offset or aggregated. Some examples of potential improvements follow:

- Divide operating expense into fixed and variable, or controllable and noncontrollable, or discretionary and nondiscretionary categories **[p. 15-16, 23, 28]**

- Display the types and amounts of costs included in certain major captions, for example:

  - disclose the portions of cost-of-sales that relate to purchased materials, salaries, fringe benefits, occupancy costs, property taxes, and other major components of costs **[p. 16, 28]**

  - disclose selling expenses separately from general and administrative expenses **[p. 15, 28]**

  - disclose the portion of cost-of-sales and SG&A expenses that is depreciation **[p. 16-17, 28]**

  - disclose the portion of costs and expenses that relate to employees versus those that do not **[p. 16, 28]**

  - disclose research and development expenditures **[p. 16-17]**

  - disclose the cash versus non-cash parts of expenses **[p. 22]**

  - disclose details of the equity income line item in financial statements **[p. 10]**

  - disclose amortization and its nature, separately from depreciation **[p. 25, 26]**

  - for financial institutions, separate disclosure of securities gains and losses from operations **[p. 41]**.

<u>Comprehensive income:</u>

Users have no strong view about whether items that are charged directly to equity, such as currency translation adjustments, should be displayed on the face of the income statements as separate elements of comprehensive income.

- Many users don't care about the geography of items that are direct charges or credits to retained earnings as long as they are fully disclosed, generally, gross and net of tax, with detail sufficient for the user to assess whether they are part of core earnings **[p. 1, 3, 12-14, 27, 39-40]**.

Alternative view

A comprehensive income approach should be adopted.

- The AIMR states that the FASB should develop and implement an accounting standard that is based on a comprehensive income approach **[p. 5-6, 9]**. However, some users may view this as a call for adoption of a method that insures the detailed disclosure of all income and expense items that are not part of core earnings **[p. 7-8]**.

5(b). Balance sheet

Leading view

Users would find helpful improvements in the display of information on the balance sheet that would assist with their analyses of opportunities and risks.

- Users are not satisfied with the current balance sheet display **[p. 9, 13]**

- Users have emphasized the importance of understanding opportunities and risks related to the businesses of the companies that they follow, including risks of not realizing assets at their reported amounts **[p. 2, 3, 14]**. The current form of display on the balance sheet already provides useful information about certain opportunities and risks. Some examples of potential improvements include:

  - Provide more detail of items in other assets and other deferred charges and credits, using a lower materiality threshold than is currently used in practice **[p. 9, 13]**

  - Display separately past-due receivables or an aging of receivables **[p. 4, 6-7, 9-10]**

  - Display separately slow-moving inventory or an aging of inventory **[p. 4-7, 9-10, 12]**

  - Provide more details about the nature of and changes in valuation reserves **[p. 3, 14]**.

Users also would find helpful improvements in the display of information on the balance sheet that would assist with their understanding of a company's business and the linkage between the financial statements and actual events.

- Some examples of potential improvements include:
  - Display separately the assets and liabilities that result from unusual transactions and events **[p. 9, 13]**
  - Display separately the assets and liabilities that result from nonoperating activities **[p. 9, 13]**
  - Provide more detail of items in other assets and other deferred charges and credits, using a lower materiality threshold than is currently used in practice **[p. 9, 13]**.

5(c). Cash flow statement

<u>Leading view</u>

A majority of users prefer a direct method of reporting cash flows from operations over the indirect method. Some users would find it most useful if the cash flows from operations portion of the cash flow statement included the same captions as on the income statement (i.e. a cash-basis income statement). However, the details of presentation of the direct method were not definitively discussed.

- Users prefer a direct method for the following reasons:
  - The direct method more closely tracks real-world events (such as the receipt of cash from customers, payment of cash to suppliers, employees, and others). Thus, it improves the users' understanding of the company's business **[p. 1-2, 13-14, 20, 22]**
  - Users use the cash flow statement in part to assess the "quality" of the company's reported income. That assessment is made easier by a line by line comparison of captions on the income statement to the cash flow equivalent of those captions on the cash flow statement **[p. 16-17, 22]**
  - Users need to know the cash flows related to certain captions of the income statement to assist in their predictions of core income and core cash flows **[p. 20-21]**. Those captions include the cash portions of (a) restructuring charges, (b) nonrecurring, unusual, and infrequent items, (c) discontinued operations, and (d) extraordinary items **[p. 22]**

- The breakdown of gross cash flows in the direct method into general categories such as cash received from customers, and cash paid to employees and vendors provides insight that is not available from the reconciliation of net income to cash flow using the indirect method **[p. 20]**.

Notwithstanding their interest in the direct method of reporting cash flows, users would still want and use the indirect reconciliation of earnings to operating cash flows if the direct method is provided.

- The reconciliation helps in identifying certain items; for example, non-recurring items that are hard to determine under the direct method **[p. 16, 19]**
- There is a concern that information from use of the indirect method might be lost without the reconciliation **[p. 18]**.

Some users would like to have a quarterly cash flow statement.

- Quarterly information would assist greatly in trend analysis **[p. 12-13]**.

<u>Alternative view</u>

Some users prefer the indirect method.

- In the view of a few users, in the direct method, obtaining information about cash received from customers and paid to suppliers and employees is worthless **[p. 10]**.

6. Unconsolidated Entities

<u>Leading view</u>

The proportionate consolidation method for accounting for unconsolidated entities should be rejected in favor of the equity or expanded equity method.

- The main objection to the proportionate consolidation method is that it results in a loss of information because numbers related to unconsolidated subsidiaries are combined with numbers related to the holding company and its fully consolidated subsidiaries **[p. 2, 9-10, 13-14, 16]**

- There is no strong preference among users for either the equity or expanded equity method provided the same level of information (including footnote disclosures) is available under each method **[p. 2-3, 9-10, 13-14]**

- Users have no strong views on the appropriateness of the 20% criterion used to determine whether an unconsolidated entity should be accounted for using (primarily) the equity method **[p. 7-8]**.

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

- Investments in unconsolidated entities are increasing in popularity and users believe that the current disclosure of information about them is not satisfactory **[p. 3-7, 11-12, 16-17]**. Many (more creditors than investors) would prefer to have full financial statements for all or at least for each "significant" unconsolidated entity and would define "significant" using a 10% criterion rather than the SEC's 20% criterion (prescribed by Rule 3-09 of Regulation S-X) **[p. 4-5, 10-12, 16-17]**. Some users would restrict the "full financial statements" requirement to only significant investee using a 20% criterion because of cost/benefit considerations **[p. 3, 6]**. Some investors believe that it is more important to get more information about each significant investee than aggregated information for "nonsignificant" investees because the latter information might be misleading **[p. 6-7]**. At a minimum, information about the composition of the "other income" line in the income statement and the "equity investment" line in the balance sheet should be provided **[p. 3, 6]**.

<u>Alternative view</u>

No preference for any of the three methods as long as appropriate disclosure of information about unconsolidated entities is provided in the notes to the investor's financial statements.

- This view is conditional upon getting more information in the notes to the financial statements than is currently provided **[p. 11, 16]**.

7. Intangible Assets

7(a). Goodwill

Note: This section should be read in conjunction with section 8(b) on business combinations.

Leading view

The accounting treatment for purchased goodwill, that is, recognition as an asset and amortization over estimated useful life, should not be changed.

- Most users make adjustments for goodwill; the amortization charge is almost always added back to income because it is a noncash charge **[p. 5-7, 10-11, 15-18]**, while the goodwill asset is sometimes, but not always, deducted from equity **[p. 5, 7, 9, 11, 15-16, 21]**. Although they generally make those adjustments, users prefer retaining the existing accounting treatment for goodwill because:

  - The information needed to make the adjustments is clearly disclosed (except in some cases where the amortization charge is aggregated with other charges **[p. 14-15]**) in the financial statements of the current year and the previous years (as opposed to being buried in stockholders' equity) **[p. 7, 11-12, 16, 19, 21]**

  - The "excess" paid for a company is useful analytical information that should be preserved **[p. 7, 11-12, 16-20]**

  - The unrecovered cost is generally included in ratios such as return on total assets and return on equity **[p. 17-19]**.

The maximum amortization period of 40 years should be significantly shortened, at least to 20 years.

- 40 years is considered too long in today's economic environment **[p. 4, 10, 12, 19, 21]**

Self-developed goodwill should not be recognized as an asset.

- Although users acknowledge that recognizing only purchased goodwill as an asset results in a lack of comparability among companies **[p. 2-3, 6-7]**, they oppose recognition of self-developed goodwill because of valuation difficulties **[p. 3-5]** and a desire to retain a transaction-based accounting system **[p. 3-5]**.

<u>Alternative view A</u>

Purchased goodwill should be written off directly against stockholders' equity at the date of purchase.

- The value of purchased goodwill is relevant only at a specific point in time (that is, at the date of the purchase transaction) and is not indicative of future cash flows **[p. 1, 5]**

- Immediate write-off against stockholders' equity would facilitate comparisons between companies that purchased goodwill and those that developed it **[p. 2-3, 6-7]**

- Write-off against stockholders' equity rather than against earnings is preferred by users **[p. 19-20]**.

<u>Alternative view B</u>

Purchased goodwill should be recorded as an asset and not be amortized or written off unless permanently impaired.

- Goodwill does not necessarily depreciate systematically; in some cases, it might even increase in value over time **[p. 13-14]**.

7(b). Other intangible assets

<u>Leading view</u>

The accounting treatment for purchased intangible assets, that is, recognition as an asset and amortization over estimated useful life, should not be changed.

- Users do not necessarily make adjustments for purchased intangible assets as regularly as they do for purchased goodwill **[p. 7-8]**

- Intangibles that are purchased individually should be recognized as assets because their purchase price has relevance to the value of expected future cash flows related to those specific intangibles **[p. 6, 8]**.

The maximum amortization period of 40 years should be significantly shortened.

- The main reason is to get back as soon as possible to a comparable basis of accounting between companies that purchased intangibles and those that developed them internally **[p. 5]**.

Self-developed intangibles should not be recognized as assets.

- The main reasons for that view are valuation difficulties and the lack of relationship between the costs of developing the intangible assets and the value of the expected future benefits arising from them **[p. 5-6]**.

<u>*Alternative view*</u>

All intangible assets arising from contractual arrangements, and for which future cash flows can be estimated, should be capitalized as assets on the balance sheet at the present value of estimated future cash flows.

- This approach would recognize the increasing importance of intangibles in today's economic environment **[p. 1-2, 4, 6]** and would focus on an appropriate measure of economic value for analytical purposes **[p. 6]**. [Refer also to **section 8(c)** on accounting for leases and other executory contracts.]

8. Alternative Accounting Procedures

<u>*Leading View Reflected in the Four Topics Under this Title*</u>
Neither investors, creditors, and their advisors are deeply concerned about the technical aspects of accounting questions, including those about alternative accounting procedures, as long as adequate information is disclosed about the method a company uses and related matters to enable them to adjust the reported results in ways they think necessary. In general, the more technical the question, the more likely they are to be largely indifferent to the arguments and concerned with adequate disclosure.

8(a). Procedures based on choice, such as accounting for inventories and depreciation

Note: All fifteen pages in this subcategory of the database except the last (excerpts of interview of a sell-side analyst and an article by French analysts) came from the Investors and Creditors Discussion Groups. The subject came up briefly in the discussion with investors 10/16/92, and the meeting materials and postmeeting questionnaires for the investors group meeting 12/9/92 and the creditors group meeting 2/2/93 asked specific questions about the desirability of eliminating managements' free choice of alternative accounting methods, such as FIFO and LIFO for inventories, straight-line and declining-charge methods for depreciation, successful-efforts and full-cost accounting for oil and gas companies, and trade-date and settlement-date accounting for securities firms. Meeting materials for the two groups differed, but the postmeeting questionnaires asked both groups the same questions.
The *Leading view* was readily apparent in the discussions and was confirmed by the postmeeting questionnaires. The two *Alternative views* also were expressed in the discussions, but their relative strengths were not evident until the responses to the questionnaires were analyzed.

<u>*Leading view*</u>

If the inventory or depreciation method a company uses is clearly disclosed, there is no reason to restrict management's choice of the method that is most appropriate for the company. Some would carry that view a step further, saying that companies should be able to choose the method, but choice of one should be accompanied by supplemental disclosure of results of applying the alternative method.

- The following are typical explanations given by those who favor the view just described:

  - To analysts, differences in the companies they follow, even within the same industry, are reasons for different accounting methods, not reasons to require companies to standardize inventory or depreciation methods. Disclosure of the methods used and their effects is better in giving a level-playing field than standardization of accounting method [p. 3]

  - Each analyst prefers to make his or her own adjustments, and there is plenty of room for different accounting methods if analysts know which methods are being used [p. 3]. The methods being used should be disclosed because the analyst, not the accountant, is then in the position to know the adjustments to make. [p. 7] All companies should not be made to fit in the same box, but full disclosure is needed so that each analyst can make up his or her own mind [p. 5]

  - The inventory problem is not LIFO versus FIFO but the age of the inventory, whether or not it's obsolete. The depreciation problem is not straight-line versus sum-of-the-years'-digits but lack of confidence in the useful life chosen. Choice of method is less relevant than having the right number of years [p. 4]

  - In many industries, a discussion about FIFO or LIFO or straight-line or sum-of-the-years'-digits never comes up until there is a problem ...[p. 4]. Until there is an earnings problem, no one asks about the differences between LIFO and FIFO [p. 5].

<u>Alternative view A</u>

Although companies generally should be able to choose between alternative inventory and depreciation methods provided that the method used is disclosed, a rule requiring that all companies use the same accounting method might be useful in some industries or on an industry-by-industry basis.

- With regard to eliminating alternatives, everybody should not necessarily be doing the same thing because the needs of one industry may be completely different from another, for example, what is good for retail probably isn't good for basic industry, or what the users of a basic industry's financial statements want isn't the same as what users of a financial services industry's financial statements would want. Maybe we need specific accounting practices for an industry and no alternatives [p. 1]

- There should be more standardization of inventory and depreciation methods but not going so far that everybody has to use the same methods. Standardization should

be along industry lines [p. 2]. Different methods are appropriate for different industries [p. 9]

- Alternative accounting methods are less straightforward beyond inventory accounting. The difference between successful efforts and full costs can be huge and not simple to pin down and can result in sudden huge write-offs [p. 1].

Alternative view B

Only one inventory or depreciation method should be permitted.

- Need for comparability outweighs whatever conceptual merits particular methods may have [p. 7-9, 13]. Alternative methods make numbers hard to compare, and management should not be able to choose between FIFO and LIFO [p. 15]
- Only FIFO should be permitted because it better reflects the way inventories are managed and thus better reflects inventory costs and gross profits on sales of invenory, while LIFO can artificially boost profits through decreasing units on hand at year-end [p. 7, 11]
- Only LIFO should be permitted because it dampens the effects of inflation on gross profits and can be used for tax purposes only if used for financial reporting as well [p. 8, 12]
- Only straight-line depreciation should be permitted because most companies already use it, and there is little or no reason for a small minority to be different [p. 8-9, 13]
- Only accelerated depreciation should be permitted because it better reflects the way plant and equipment assets wear out and already is widely used for tax purposes, and its use in financial statements would decrease the differences between reported net income and taxable income [p. 9, 14].

8(b). Procedures based on criteria, excluding accounting for leases, such as accounting for business combinations

Note: All thirteen pages in this subcategory of the database except the first (some rather general comments from AIMR, *Financial Reporting in the 1990's and Beyond*, p. 16 and 17) came from the Investors and Creditors Discussion Groups. The meeting materials and postmeeting questionnaires for the investors group meeting 12/9/92 and the creditors group meeting 2/2/93 asked specific questions about the desirability of eliminating either the pooling of interests method or the purchase method of accounting for business combinations. The subject of accounting procedures based on criteria also

came up again in discussion of other subjects in the investors group meeting 1/13/93 and the creditors group meeting 3/11/93.

The *Leading view* and all three *Alternative views* were expressed during the discussions, but which view or views had wide support and which had only minority support did not become evident until the responses to the postmeeting questionnaires were analyzed. Most comments favoring one method or the other or tolerating both seem to have been based less on enthusiasm for one of the methods than distrust of the other, or distrust of both. Participants generally seemed more aware of, or more perturbed by, the weaknesses and abuses of the purchase method, saying less about the weaknesses and abuses of the pooling of interests method.

Leading view

Companies should continue to be able to structure business combination transactions in a way that permits use of either the purchase method or the pooling of interests method if disclosures about combinations accounted for by the purchase method are expanded to provide information needed to compare net income before and after the business combination and the rules for applying both methods are strengthened.

- Current accounting principles for acquisitions basically are working except there is not enough disclosure under purchase accounting about how the assets are written up or down at acquisition and about the reserves created at acquisition and how those reserves are utilized in later periods [p. 5]. For example, inventories purchased are written down and then sold later with the result that a nonrecurring gain not only is not disclosed but also is reported as operating income [p. 3, 5]

- Acquisitions is an area that the typical analyst looks at with a great deal of skepticism because it appears that opportunities are taken to manage the numbers or the process to the company's benefit. Criticism that the purchase method distorts future reported results is matched by criticism from the other direction that the pooling of interests method gives companies the ability to really buy off multiples, burying the premium that the buyer pays [p. 8]

- Purchase accounting is acceptable for very small combination transactions involving single purpose entities, but a merger of two very large financial institutions is not a purchase, and the distortions resulting from purchase accounting are significant. The merger of operations of that size and scope must retain the basic concept of historical cost accounting without having to revalue every asset in today's transaction price. The pooling is going to be a much more appropriate reflection of that business combination than the purchase method [p. 7]

- Rules for applying the purchase method need to be strengthened to prevent abuses that allow net income after the business combination to be inflated by use of overly conservative fair values for assets acquired, or liabilities assumed, in the combination transaction [p. 13]

- Rules for applying the pooling of interests method need to be strengthened to prevent abuses that allow net income after the purchase transaction to be inflated by profits on sale of assets acquired in the combination transaction based on costs (book values) that ignore the (normally higher) price paid to acquire the assets in the business combination [p. 13]

- The two methods do not fit the same circumstances, and there is no real problem in having two of them [p. 3]. Each has its weaknesses, and each has been abused, but they work pretty well [p. 5].

Alternative view A

Only the pooling of interests method should be permitted.

- Choice of accounting method makes a difference. Purchase accounting makes analysis difficult going forward because the value of the assets are stepped up or down, affecting reported results for several periods. Lack of comparability is an issue of one accounting method chosen versus another. It would make analysis somewhat easier if one method or the other were applied to all transactions [p. 6-7]

- The pooling of interests method preserves trends and thus facilitates interperiod comparisons—the assets, liabilities, revenues, expenses, and earnings or net income of the combined company are readily compared with those of the constituent companies before the combination—while the purchase method tends to disrupt trends and make the company after the business combination less readily comparable with the constituent companies before the combination [p. 11].

Alternative view B

Only the purchase method should be permitted.

- The purchase method reports the economic reality that most, if not all, business combinations are acquisitions of one company by another, while the pooling of interests method ignores the bargaining that led to the combination transaction, thus opening the way for the acquiring company to report as profits on sales of the acquired assets significant amounts that the purchase method more accurately reports as costs of acquiring the assets [p. 12].

8(c). Accounting for leases and other "executory" contracts

Note: About one-third (pages 1-6) of this subcategory of the database consists of excerpts from AIMR, *Financial Reporting in the 1990's and Beyond*, p. 29-34 and 59-62, which recommends capitalization of leases, a view shared by some members of the investors and creditors groups, and also of all other "executory" contracts (contracts awaiting performance by both parties). Two-thirds (pages 6-16) concerns leases only and came from the Investors and Creditors Discussion Groups. The subject of leases was raised briefly at the investors group meeting 10/16/92 and at the creditors group meeting 12/8/92. The meeting materials and postmeeting questionnaires for the investors group meeting 12/9/92 and the creditors group meeting 2/2/93 asked specific questions about the desirability of accounting for all leases by the same method, eliminating either the operating lease method or the capital lease method. Leases came up briefly again in discussion of other subjects in the creditors group meeting 3/11/93. Dissatisfaction with present practice seemed to underlie much of the discussion and many of the views, even of those who wish to retain both the capital lease and operating lease methods.

There seem to be three *Leading views*, but the degree of support for any view is hard to assess from the data. The matter is complicated by the small number of questionnaires returned by the investors group and by wide dispersion in answers to the questions about leases in the questionnaires shown by the following tabulation, such as the apparent disagreement between the investors and creditors groups in ranking each of the five views and the apparently contradictory rankings in the creditors group: at least half ranked each of three essentially opposing views—(a), (c), and (d)—as 1 (most preferred) or 2 (next most preferred).

The question asked respondents to rank five views (which are identified by letters here that were not in the questionnaire) with 1 meaning most preferred, 2 meaning next preferred, and so on to 5 meaning least preferred, using each number only once.

		Most←preferred→Least				
		1	2	3	4	5
a. All leases other than month-to-month leases and leases whose terms do not extend past the balance sheet date should be capitalized	Creditors	6	1	3	3	1
	Investors	1	1		1	1
b. All leases should be accounted for as operating leases	Creditors	1		2	4	5
	Investors	2				2
c. Some leases should be considered operating leases, while others should be capitalized....	Creditors	4	5	3	1	
	Investors			2	1	
d. The problem with lease accounting lies less in whether or not they are capitalized and more in the fact that the following disclosures are missing or inadequate....	Creditors	3	7		2	
	Investors		1	1	1	
e. Lease accounting should eliminate operating lease alternatives, at least for some assets, but the determination should be specified on an industry-by-industry basis	Creditors			4	2	6
	Investors	2	1		1	1

A leading view regarding disclosing information about leases is readily identifiable in responses to the questions in the meeting materials or questionnaires.

<u>Leading view</u>

Regardless of their views on whether or not leases should be capitalized, investors, creditors, and their advisors believe that present disclosure of information about leases is inadequate and want cash flows specified by leases and other information to be disclosed.

- Full disclosure of the obligation under the lease agreement is more meaningful than the way the leases are accounted for on the balance sheet. It is more important to have full disclosure than to account for the lease in a specific way **[p. 8]**
- Need separate disclosure of lease obligations by type of asset, for example, real estate, major operating assets, and tangible personal property **[p. 13, 15]**
- Need disclosure of maturities of lease obligations by grouping separately leases with short, medium, and long terms **[p. 13, 15]**
- Need to distinguish lease obligations by separating obligations representing inescapable future cash payments from obligations which in, say, bankruptcy, would only extend a limited time regardless of the specified lease term **[p. 13, 15]**

- Disclosing present value of operating leases could substitute for capitalization [p. 13]

- As long as an analyst gets the information, he or she can make the adjustments and analyze the effects [p. 12].

Note: Two views regarding capitalizing leases—(a) and (c)—also may be leading views but because they are opposing views, they probably should be considered to be significant alternative views.

Alternative view A

Some leases should be operating leases, while others should be capitalized. The difference depends principally on ______________________
Of the bases suggested by the questionnaire, only lease period ranked reasonably high, with "strongly agree" on two and "agree" on seven questionnaires. The other two bases—amount of lease payments relative to the value of the leased asset (asked only of investors group) and industry and/or type of asset being leased—received low ranking from respondents. The following are other bases suggested by respondents: who bears economic risk as an indication of true ownership, intention to renew, whether or not lease substantially uses up economic life of asset leased, and whether or not ownership transfers at end of lease.

- In the airline industry, for example, planes can be leased for one, two, three years—for a limited period of time. And that is all the obligation that the airline has, as opposed to a financing lease, which is a 25-year obligation. To have the same accounting for both would not do justice to the flexibility that the company would have from entering into an operating lease [p. 10]

- The criteria for distinguishing a capital lease from an operating lease constitute a form test—a transaction can be structured in a way to get a certain kind of accounting. Maybe this is not a question of a choice between alternative methods but that the form test is not the right form test. The right criteria? A twenty-five-year lease is pretty clearly a capital lease regardless of what, but a five-year lease is less clear, right in the middle of gray [p. 10]

- Companies enter into financial arrangements for more than just accounting; there are true economic benefits. It's not clear that the current accounting test finds the right break between operating and capital leases [p. 11, 12].

<u>Alternative view B</u>

All leases other than month-to-month leases and leases whose terms do not extend past the balance-sheet date should be capitalized. This apparently includes views of users who follow industries such as airlines and retail merchandising and believe that all airplane leases or retail store leases should be capitalized. This also includes views of those who would extend capitalization to all executory contracts with an initial duration of more than one year, including employment agreements and similar contractual arrangements, without weakening standards of revenue recognition.

- A short-term lease for airplanes should be capitalized. An airline needs airplanes to be a going concern, and payments on airplane leases are like other fixed charges. The way to see the leases' impact on the airline's capital structure is to capitalize them **[p. 11]**

- Operating leases need to be adjusted back as if they were capital leases for analytical purposes, for leverage calculations as well as interest cover. Interest cover based on a lease is part of the analysis **[p. 9]**. Whether or not leases are adjusted depends on the industry. Operating leases are automatically added back and treated as capital leases for retailers and transportation, for example, but not for certain other industries **[p. 11]**

- Capitalization of all executory contracts (those awaiting performance by both parties) with an initial term in excess of one year would eliminate many of the problems that plague lease accounting and would place on the balance sheet at least some of the quite real intangible assets—rights to anticipated future cash flows—that do not now appear. Contractual rights are often more significant to service and other nonmanufacturing businesses than are tangible assets but now are not recognized until the anticipated cash is received unless they are acquired in a purchase transaction with an unrelated party **[p. 1, 3]**

- Existing rules for accounting for leases are arbitrary and the application often is willfully capricious. The rules have become complicated and excessively detailed because they are designed to foil the machinations that often accompany the classification of lease agreements as operating or capital leases, but instead of introducing comparability and consistency into lease accounting they invite persons having sufficient motivation to study their particulars to be able to write lease contracts that produce desired outcomes **[p. 3, 6]**.

<u>Alternative view C</u>

Leases are a perfect example of things that need not be in the balance sheet but just put in the notes. It would simplify matters greatly if every lease were accounted for as an

operating lease coupled with note disclosure of the terms of the lease and the cash flows.

- The question is the company's real liability because the lessee is responsible for the full value of the rents. The present value of a capitalized lease does not disclose the total amount the lessee is going to have to pay, that is, the total cash outflows **[p. 10]**

- The reported liability, either capitalized or disclosed in a note, may not be the true legal liability because of adjustments that can occur, through liquidation or bankruptcy or otherwise **[p. 10-11]**.

8(d). Other

Note: The three pages of this subcategory of the database consist of a comment by one analyst on alternative transition procedures permitted by FASB Statement No. 106, *Employers' Accounting for Postemployment Benefits Other Than Pensions*, which is more pertinent to subcategory 2(c) on comparability, expressions of preferences on certain alternative accounting procedures and expressions of support by a committee of Robert Morris Associates for FASB Statements No. 109, *Accounting for Income Taxes*, No. 87, *Employers' Accounting for Pensions,* and No. 106, and expression of support by a committee of the Association for Investment Management and Research for reporting marketable equity securities at market value instead of cost or market, whichever is lower, which is more pertinent to **section 4** on value information.

9. Measurement Uncertainties

Note: The estimates involved in asset and liability measurements are referred to as measurement uncertainties. The estimates are required since some of the amounts of the assets and liabilities at the reporting date are uncertain; whether those amounts are materially correct will be confirmed by future events. Users displayed some confusion about the meaning of measurement uncertainties and, to some degree, the discussion of this topic reflects that confusion.

Leading view

A boilerplate statement that certain of the accounting amounts are based on estimates and assumptions and are not as precise as they appear would be useless to professional investors. However, such a statement might serve as a positive reminder to unsophisticated investors.

- Professional investors already know about the imprecision of some financial statement numbers. A boilerplate disclosure stating this is unnecessary and redundant. It can be viewed as a device to attempt to limit legal liability but is of no value to professional investors **[p. 2-3, 13, 16]**

- Although of no value to professional investors, a boilerplate statement may serve as a warning and may be helpful to unsophisticated investors who may forget that a certain amount of imprecision is inherent in financial statement amounts **[p. 13-14, 16]**.

There is general agreement that disclosures should be made about the detailed estimates and assumptions used to determine material asset and liability amounts unless the disclosures would result in a competitive disadvantage.

- Users very strongly support such disclosures. Accounting amounts have the appearance of precision but they are not precisely determined in transactions for other than cash. As a result, users need to know how the numbers are derived **[p. 1, 2-6, 14, 16]**

- Regardless of the importance of the estimates and assumptions used, they should not be disclosed if such disclosure would cause competitive disadvantage for or prejudice the negotiations of a company. Disclosures about certain events such as the amount for which a company might be willing to settle a law suit or a bank's willingness to accept some accommodation regarding a troubled loan represent almost "blank checks" to the other party and would be disadvantageous to the company's shareholders **[p. 6]**

- Although users believe that disclosures should be made about the detailed estimates and assumptions used to determine certain material asset and liability amounts, they are split on whether the information disclosed should be (1) developed by managements and their auditors, based on professional judgment or (2) mandated by standards setters, creating a uniform disclosure requirement. Permitting information to be developed by managements and their auditors provides needed flexibility in selecting those disclosures that are necessary for users to better understand financial statements. Mandating an accounting standard insures that companies will report and that similar events and circumstances will be treated in similar ways **[p. 14, 16]**

- Some detailed disclosures about estimates and assumptions are already required by GAAP or the SEC. Subject to the caveat that providing information about assumptions and estimates for <u>all</u> accounts would be a logistic nightmare, in many cases, users believe that present disclosure requirements are inadequate, and there is strong sentiment for improvement **[p. 2, 4-6]**. The accounts for which disclosure is sought vary considerably based on the materiality and importance of the account in a particular industry or to a particular company. Users have specified an array of data for various accounts to be disclosed including:

  - Information about the change in the <u>nature</u> of the warranty for a product; for example, has coverage under the warranty or the warranty period changed? However, for the assumptions to support amounts, for example, the experience estimate of problems that will occur during a warranty period, management knows better than anyone else **[p. 5]**

  - The determination of the effect of inventory obsolescence is critical to performance evaluation in some cases **[p. 3]**. Unsold out-of-fashion ladies clothing has no value.. The value of unsold automobiles at the new model introduction date diminishes, however, they still retain significant value

  - Stage of completion and status of construction costs on contracts is a critical factor in the analysis of companies materially involved in such contracts **[p. 2-3, 13, 15]**

  - Interest rate, actuarial and other assumptions used in present value and other measurement determinations applied by managements, for example, in determining pension and health care costs and obligations, reserving, asset life, return on operating assets, mortgage banking transaction amounts, etc. Such information would help determine the validity of the assumptions actually used **[p. 1, 4, 6, 11]**

- The determination of environmental exposure (both identification and measurement) is critical in the manufacturing industry where environmental risk is extraordinary **[p. 4]**.

10. Operating Opportunities and Risks

10(a). Definition

Leading view

For financial reporting purposes, operating opportunities and risks are defined to be beneficial or detrimental circumstances in which the reporting entity is involved at the reporting date that are not assets or liabilities but that may cause the reporting entity to have increases or decreases in cash flows in the future.

- Several users agree with the definition as representing the types of operating opportunities and risks that should be considered for disclosure **[p. 1-3]**
- Some users, while agreeing in general with the definition, found the definition to be deficient in the following respects:
  - The definition does not deal with the notion of risk mitigation **[p. 1]**
  - The definition provides no guidance as to the distinction between concerns versus "strong beliefs" about positive events **[p. 2]**
  - The definition fails to clearly describe the required degree of involvement of an entity in beneficial or detrimental circumstances for the circumstances to be disclosed **[p. 3]**.

10(b). Types of opportunities and risks that should be disclosed

Leading view

Users welcome more information about operating opportunities and risks in external financial reports. Particularly, they are interested in disclosures about operating risks.

- Users want information about opportunities and risks that are relatively near-term, relatively certain and relatively quantifiable **[p.12]**. Assessments by accountants should not result in forecasting an event. That is the job of management and users **[p. 11-12]**. Most creditors strongly agree that disclosure of operating opportunities and risks should focus on specific, clear identifications of near-term events and circumstances rather than discuss unspecified possibilities, probably on a company specific rather than an industry basis. Identification of opportunities and risks, rather than interpretation, should be the goal **[p. 14]**

- Users want information about opportunities and risks resulting from concentrations in assets, customers and suppliers. Information about concentrations may be material, is quantifiable and disclosure is appropriate [p. 6-7]. Although the reasons are not specified, users believe that the following types of information should be disclosed:

  - Large increases or decreases in the proportion of materials purchased from the one or two largest suppliers [p. 15]

  - Large increases or decreases in the proportion of products or services sold to the one or two largest customers [p. 15]

  - Concentration in assets resulting from unusual or special circumstances such as, for example, bad loans that eventually become real estate because of collateral repossessions [p. 7]

  - Information about geographic concentrations in the production base of a company (as well as the sales base) [p. 6]

- Some users agree that illiquidity should be discussed if it makes a company vulnerable to risk of severe impact on near-term cash flows or results of operations [p. 7]. Most users believe that one of the factors that warn about the risk of illiquidity, a growing inability to pay suppliers and lenders on time, should be disclosed [p. 15]

- Contingent loss disclosure becomes more important as the potential amount becomes larger and more quantifiable. Users want to know "immediately" about potentially "life threatening" events in a company [p. 8]. Environmental problems such as potential asbestos related liabilities is an example [p. 16]. Disclosure of material, but not "life threatening" events, is important but has a longer time frame [p. 8]. The time frame is a matter of user judgment [p. 8, 16]. It is not a subject easily reducible to an accounting standard or SEC edict [p. 2, 4-5].

The SEC MD&A requirements, which focus on events and uncertainties that would cause the reported information to be an inadequate indicator of future operating results, represents a good framework for disclosures about operating risks, although current MD&A disclosures are not satisfactory.

- Most users agree the MD&A is a better location for disclosure of opportunities and risks than the financial statement footnotes [p. 13]

- Users identify these weaknesses in some current MD&A disclosures:

  - Management tends to overstate the opportunities and understate the risks that it sees **[p. 1-2; section 10(d), p. 4]**

  - Disclosures tend to be in the nature of broad disclaimers **[p.2]**

  - Disclosures use descriptive phrases (boilerplate) and the discussion includes information about accounting items that are not necessarily the relevant business issues **[p. 2, section 10(d), p. 4]**

  - Disclosures are met at the minimum **[p. 4]**

- Users of financial statements of private companies would welcome a MD&A type disclosure but are concerned whether the cost could be justified **[section 10(d), p. 5-6]**.

Users are generally not in favor of allowing management to use subjective screens to determine the nature and extent of disclosures to be made about operating opportunities and risks.

- The application of the following screens for limiting the number of risks that might have to be disclosed is viewed as unworkable, oversimplified and misdirected:

  - If it is at least reasonably possible that the future events that will convert risk to loss and perhaps liability will occur

  - If that future event carries the risk of severe impact on the company

  - If that impact will be on near-term cash flows or results of operations of the company

  - If the risks are other than those generally known to be associated with the industry or trade in which the entity operates

- A definitional problem in providing disclosures parameters exists. "Reasonably possible" cannot be adequately defined. Every user makes his or her own assessment **[p. 7-8]**

- The screens are not adequate. Risks are related to each other and cannot be segregated. A small risk when related to others may need to be disclosed **[p. 8]**

- Users want to be able to review all information that they can secure. They don't want anyone screening it, particularly management **[p. 8-9]**

- Although examples are sometimes useful in defining what is to be screened, they are frequently so general that they aren't helpful **[p. 9]**.

Alternative view

Requirements to disclose operating opportunities and risks is unlikely to be productive in practice.

- Reasons cited for low likelihood of productive disclosure include:

    - Too much of the potential disclosure involves information that would be competitively disadvantageous to disclose **[p. 2, 12]**

    - Creditors and by implication, investors, are split on whether the following types of information should be disclosed. Although the reason for the split are not stated, it would appear that some believe the data is viewed generally as so sensitive that any information provided would not be helpful:

        - The possibility of new competitors **[p. 15]**
        - The possibility of substitute products **[p. 15]**
        - Changes in the bargaining power of suppliers **[p. 15]**
        - Changes in the bargaining power of customers **[p. 15]**

    - To avoid litigation exposure, disclosures may be excessive and boilerplate **[section 10(d), p. 7]**

    - Difficulties in quantifying disclosures and inability to distinguish "reasonably possible" future risks will make useful disclosure impractical **[p. 7-8, 11-13]**

    - Identification of opportunities and risks is the job of analysts, not accountants, and analysts have significant access to management and other tools to do this **[p. 3, 9]**

    - The needed improvement in MD&A disclosures is not likely to be achieved by a rules change **[section 10(d), p. 4-5]**

    - Any attempt to "screen" disclosures or otherwise selectively choose the disclosures to be made will result in inconsistent reporting among companies and year-to-year as judgments change **[p. 8]**

    - For small companies, the cost may drive issuers away from issuing audited statements **[section 10(d), p. 6]**.

10(c). Content of disclosures about opportunities and risks

Leading view

Giving due consideration to cost, users want detailed specific disclosures about operating risks.

- Users want information about opportunities and risks that are relatively near-term, relatively certain and relatively quantifiable **[p, 12]**
- Users have interest in specific risks or those that are unique or different from that which someone would expect for the industry **[section 10(d), p. 8]**
- Users are interested in sensitivity disclosures with respect to interest rates and exchange rates, but not inflation rates. Other types of sensitivity reporting or stress testing would be welcomed **[p. 1-2; section 10(b), p. 5-6, 14]**
- Users identified environmental liability risks as a particular interest **[section 10(b), p. 15-16; section 10(d), p. 1]**
- More disclosure should be required for risks related to derivative financial instruments **[section 10(b), p. 5-6].**

11. Interim Reporting

11(a). Frequency of interim reporting

Leading view

The optimal period for interim reporting is quarterly.

- Quarterly interim information is needed and used primarily as an early warning or predictive indicator **[p. 1-5]**
- Anything shorter than quarterly would contain too much "noise" or static **[p. 8-9]** and anything longer would not be timely enough and could worsen the insider trading problem **[p. 2-4]**. Quarterly interim reporting is a long enough period of time to identify and analyze trends **[p. 9-10]**
- Notwithstanding their preference for quarterly interim reporting, users still want immediate disclosures of important events occurring between interim reports **[p. 1]**.

11(b). Periods covered by financial statements

Leading view

Interim information should be provided for each quarter of the reporting year.

- Users strongly favor the presentation of separate fourth quarter interim information **[p. 1, 3-5]**.

Interim information should also be presented on a cumulative basis.

- Some users prefer "rolling twelve months" information over cumulative year-to-date information because it facilitates comparisons among companies **[p. 2]**
- Other users believe cumulative year-to-date interim information is preferable to rolling twelve months information because it is not affected by the previous year's year-end adjustments **[p. 2, section 11(c), p. 11, 13]**.

11(c). Content of financial statements and related disclosures

Leading view

More interim information than is currently provided is needed but not necessarily as much as is provided in full financial statements.

- Users are particularly interested in getting more interim segment information **[p. 2, 5, 7-8, 11, 13-14]** and an interim cash flow statement **[p. 3, 6]**. Other suggested information to be provided in interim reports include: key captions of the balance sheet, income statement, and cash flow statement **[p. 14]**, standardized debt and book value ratios **[p. 2]**, and backlog information for a contractor **[p. 9]**.

Alternative view

Full financial statements should be provided in interim reports rather than summarized information.

- This view is supported more by investors than by creditors **[p. 3-4, 10-13]**.

11(d). Integral and discrete approach

Note: The views and supporting arguments set forth in this section should be considered with caution. The Subcommittee believes that the comments made on this topic by most of the users surveyed partly reflect a lack of complete understanding of the technical accounting distinctions between the two approaches.

Leading view

The integral approach to interim reporting is preferable to the discrete approach, particularly if combined with adequate interim cash flow information.

- The integral approach is preferable because it deals better with "annual" items such as management bonus awards and income taxes **[p. 5, section 11(c), p. 13]**. Some users believe that the integral approach is appropriate especially if interim cash flow information is provided because the latter information compensates for the "smoothing" inherent in the integral approach **[p. 4-6]**. Some users are concerned about favoring the discrete approach because of the potential consequences on management's decisions (that is, management might make "uneconomic" decisions to "manage" the interim numbers under the discrete approach) **[p. 4-5]**.

<u>Alternative view</u>

The discrete approach to interim reporting is preferable to the integral approach, particularly in the absence of adequate interim cash flow information.

- **The discrete approach does not allow any "smoothing" of income between interim periods and clearly presents the effects of seasonal variations [p. 1, 3].**

12. Forward Looking Information

Note: In the context of the Special Committee's work, forward looking information includes both financial and nonfinancial information. The first leading view stated below applies to both types of forward looking information. However, the rest of this section applies only to financial forward looking information (loosely termed by users as financial projections or forecasts). Views on nonfinancial forward looking information are covered in **section 13** on nonfinancial business information. Section 12 should therefore be read in conjunction with section 13 to gain a comprehensive understanding of users' needs related to forward looking information.

<u>Leading view</u>

Users consider forward looking information an important part of their analysis.

- Forward looking information is used to assess:
    - Variability of the operation **[p. 1]**
    - Debt service capability **[p. 1]**
    - Additional borrowing needs **[p. 1, 9]**
    - Management's goals, expectations, and strategies **[p. 1-4, 6-8]**
    - Future revenues **[p. 6]**

- Users would welcome additional forward looking information in external financial reports, including:
    - Qualitative rather than quantitative information: broad business objectives, prospects in terms of goals for return on assets, equity, and capitalization ratio **[p. 8-9]**
    - Only some key indicators (for example, projections on revenues and new products, capex spending, and backlog information) as opposed to full forecasted financial statements **[p. 6, 11]**.

Users do not seek management's projections or forecasts.

- Users do not seek management's forecasts or projections because:
    - They are fundamentally unreliable **[p. 1-3, 5, 8-9, 12-13]**, inherently imprecise **[p. 8, 9, 12-13]**, and overly optimistic **[p. 2, 5, 7, 9, 13]**

- They encourage management to manage earnings toward previously published projections [p. 9]

- They subject the company to additional litigation risk [p. 3, 9-10]

- Access to management's projections may represent a restriction on the investors' or creditors' future activities due to the potential for receiving insider information on public securities [p. 10].

Users prefer to make their own projections and forecasts.

- Analysts view making projections part of their jobs [p. 4-5, 9, 12]

- Analysts have a broader view of the industry than management which allows consideration of competitive pressures on projected operations [p. 4, 7]

- Analysis through development of an independent projection provides better insight into a company [p. 5, 7]

- Analysts can make alternative projections, such as "worst case" scenarios, as part of their own projections [p. 1, 9, 11].

Users do not believe auditor association with projections or forecasts to be beneficial.

- Auditor association would encumber or dampen management's degree of candor in disclosures [p. 4]

- Auditors lack the broad, industry perspective needed to express an "opinion" on a projection or forecast [p. 4]

- Auditor association with financial information should focus on "clarity", not interpretation [p. 5-6]

- Auditor evaluations of future-oriented estimates would not be used in lieu of the analysts' own estimates [p. 5, 9, 12]

- Auditor association with projections or forecasts threatens auditor objectivity on subsequent reporting of actual financial results [p. 6, 12].

<u>*Alternative view*</u>

Some users, particularly lenders to small, private companies, seek to obtain management's projections or forecasts.

- Management's own view of the future is relevant to the lender **[p. 1, 4, 7, 9-10]**

- The discipline imposed on management to produce a projection or forecast is useful for both the borrower and lender **[p. 8-10]**

- It is useful to compare management's previous projections or forecasts to subsequent reports of actual results **[p. 7, 11]**.

Some users who obtain management's projections or forecasts would welcome auditor association.

- Involvement of the auditor is a means of testing the reasonableness of assumptions **[p. 1, 8]**.

13. Nonfinancial Business Information, Excluding Operating Opportunities and Risks

Leading view

Many investors who follow the fundamental approach and many creditors who provide financing on a longer-term basis have extensive needs for nonfinancial business information. The following list indicates the types of that nonfinancial information.

Users need nonfinancial business information for sufficient historical periods to permit analysis of how the segment's business performs through one or two business cycles (often about ten years). The number of periods of forward-looking information that users need depends on their objective and approach and other factors, but rarely exceeds five years.

As shown in the list, users need both information about the past and the present and forward-looking information. The information about the past and the present provides a foundation on which to evaluate or project forward-looking information. Forward-looking information helps users assess the future and the company's riskiness. Forward-looking information alone is insufficient.

In general, the users believe that nonfinancial information about the general economy is outside the scope of company-specific external reporting. (Unfortunately, the Subcommittee does not have a sufficient basis to address which of the other types of nonfinancial business information should be included in external reporting and which should be outside the scope of that reporting for reasons of costs and benefits.)

Note: The following two points are not directly supported by the database. However, the Subcommittee believes that they can be logically inferred from the material in the database.

Users need to understand the linkage and relationship between actual events and activities and the financial statements that represent the financial impact of those events and activities. Nonfinancial business information serves the critical function of helping users understand that linkage and relationship. Thus, the nonfinancial business information needs to be closely correlated to the information in financial statements. That is, the level of detail, disaggregation, and time periods covered should closely match that of the financial information that users' need.

Disaggregation of nonfinancial business information is key. Users need information on an industry and, in some cases, a geographic and line of business basis. To the extent possible, users want to evaluate industry and geographic segments as separate

businesses. Thus, the types of information listed below applies to each business segment. To the extent possible, both financial and nonfinancial information should be disaggregated on the same basis.

TYPES OF NONFINANCIAL BUSINESS INFORMATION

I. INFORMATION ABOUT THE PAST AND THE PRESENT

1. The segments' business, methods of conducting the business, and its relationships with others:

(a) segment definition

- In response to a postmeeting questionnaire, 6 of 9 investors ranked "definition of industry" as essential information [page 15]
- In response to a postmeeting questionnaire, 10 of 16 creditors indicated that they always or frequently discuss "definition of the industry" with management [page 28]

(b) description of business and industry structure

- See quotes from the following in Section 13: paragraph 5, p.1; paragraph 8, page 1; paragraph 7, page 2; paragraph 11, page 2; paragraph 1, page 5; paragraph 4, page 5; paragraph 9, page 6; and paragraph 1, page 38
- In response to a postmeeting questionnaire, a majority of investors consistently ranked "essential" information describing the business and industry structure [pages 15, 16, and 18]
- In response to a postmeeting questionnaire, a majority of creditors consistently indicated that they always or frequently discussed with management information describing the business and industry structure [page 28]

(c) financial interests and relationships among major shareholders, directors, management, and the company

- See quotes from the following in Section 13: paragraph 2, page 5; paragraph 2, page 10; paragraph 3, page 10

2. Operating data for recent periods:

- See quotes from the following in Section 13: paragraph 8, page 1; paragraph 6, page 2; paragraph 1, page 5; paragraph 4, page 6; paragraph

1, page 7; paragraph 2, page 7; paragraph 4, page 9; paragraph 7, page 11; paragraph 8, page 11; paragraph 6, page 39
- In response to a postmeeting questionnaire, 4 of 8 investors ranked nonfinancial operating data "essential", 4 of 8 respondents ranked that information "helpful" [page 17]

3. **Explanations of relationships and changes among the data, focusing on:**

(a) **key changes in amounts in the historical financial statements and nonfinancial statistics and the reasons for those changes**

- See quotes from the following in Section 13: paragraph 1, page 5; paragraph 7, page 5; paragraph 7, page 5; paragraph 4, page 6; paragraph 3, page 7; paragraph 4, page 8; paragraph 3, page 22; paragraph 4, page 23; paragraph 5, page 23; paragraph 2, page 9; page 33; paragraph 2, page 24; paragraph 3, page 24
- In response to a postmeeting questionnaire, 7 of 9 investors ranked "identity of key trends and relationships among the data" as "essential", 2 of 9 ranked that information as "helpful"
- In response to a postmeeting questionnaire, 11 of 14 creditors and 5 of 6 investors agreed that current MD&A disclosures fall short of user expectations. They indicated three reasons for that view [pages 31 and 36]
- In response to a postmeeting questionnaire, investors offered several suggestions to improve MD&A [page 37]
- In response to a postmeeting questionnaire, 10 of 12 creditors indicated that MD&A disclosures for private companies would significantly improve their financial reporting. However, the creditors were split as to whether the cost of providing the information would be greater than its value. [page 32]

(b) **measures in liquidity and reasons for changes in those measures** (Refer to Section 10, "Operating opportunities and risks" for users' views about the importance of measures of liquidity. In general, many investors and creditors consider measures of liquidity as essential information.) See paragraphs 1 and 5 page 24 in Section 13

(c) **identity and effect of unusual, infrequent, and nonrecurring transactions and events** (Refer to Section 5, "Display", for users' views about the identity and effect of unusual, infrequent, and nonrecurring transactions and events. In general, many investors consider information about the identity and effect of those transactions and events as essential in estimating core income or core cash flows.)

II. FORWARD LOOKING INFORMATION

1. Identity and possible effect of key trends

- See quotes from the following in Section 13: paragraph 10, page 2; paragraph 4, page 5; paragraph 5, page 7; paragraph 8, page 37
- In response to a postmeeting questionnaire, 8 of 9 investors ranked "identity of key trends and relationships among the data" as "essential" information [page 21]

2. Major goals, strategy, factors that are critical to successfully implementing strategy, and major plans

- See quotes from the following in Section 13: paragraph 8, page 1; paragraphs 1-5, page 2; paragraph 3, page 4; paragraph 4, page 5; paragraph 7, page 5; paragraph 1, page 6; paragraph 5, page 7; paragraph 7, page 25; page 34; paragraph 6, page 26; paragraph 2, page 39; paragraph 2, page 40
- In response to a postmeeting questionnaire, 8 of 9 investors ranked "mission and intent of segment" as "essential" information [page 18]
- In response to a postmeeting questionnaire, 13 of 15 creditors indicated that they always or frequently discussed with management the company's "mission and intent" [page 28]
- In response to a postmeeting questionnaire, a majority of investors consistently ranked as "essential" information about management's business strategy
- In response to a postmeeting questionnaire, 16 of 17 creditors indicated that they always or frequently discussed with management the company's "strategy and strategic alignment" [page 28]

3. Opportunities and risks (Refer to Section 10, "Operating opportunities and risks". In general, many users consider information about operating opportunities and risks as essential for their purposes.)

4. Measures of leading indicators:

(a) backlog

- See quotes from the following in Section 13: paragraph 4, page 11; paragraph 5, page 11; paragraph 2, page 24; paragraph 4, page 24; paragraph 6, page 25

(b) innovation

- See quotes from paragraph 2, page 24
- In response to a postmeeting questionnaire, a majority of investors consistently ranked information under the caption "ability to innovate, adapt to change, and continuously improve" as "essential" information [pages 16 and 19]
- In response to a postmeeting questionnaire, 12 of 16 creditors indicated that they always or frequently discussed with management the company's ability to innovate, adapt to change, and continuously improve [page 28]

(c) other

- See quotes from the following in Section 13: paragraph 3, page 5; paragraph 6, page 5; paragraph 3, page 6

III. COMMENTS ABOUT OTHER KINDS OF INFORMATION

1. A survey concluded that "Overall economic information seems too general and nonspecific to be useful, while forecasts by economists are viewed skeptically" [paragraph 11, page 2]

2. A survey concluded that ". . . 'quality of management' did not emerge as one of the important types of information. . . Although management quality is extremely important to investors, they believe they can best understand it by evaluating performance , reputation, market position, and other company characteristics. In other words, management quality is an inherent and inseparable aspect of the other types of information." [paragraph 4, page 3]

3. A study of analyst reports concluded that "[Sell-side analysts give] more attention. . . to management when major changes in management have occurred, [when they consider] changes that new management will bring" [paragraph 2, page 5]

4. One investor stated "I don't see programs aimed at giving [investors] information from a marketing, merchandising, and distribution point of view" [paragraph 4, page 7].

14. Other Comprehensive Bases of Accounting (OCBOA)

Leading view

Users would prefer that all general-purpose external financial statements be prepared using a single set of accounting and disclosure rules (GAAP).

- The use of OCBOA statements is opposed because it inevitably leads to a decrease in the comparability of information among companies **[p. 1-2]** and users are unable to interpret the reported information **[p. 2]**.

While users prefer GAAP statements, competitive pressures on lenders and sophisticated borrowers sometimes result in acceptance of OCBOA financial statements by creditors.

- Circumstances when OCBOA statements might be accepted include:
  - Creditors lending to small companies or for small loans where the risk of loss is limited **[p. 2-4, 6]**; in those cases, tax-basis statements are commonly accepted **[p. 3-4]**
  - When making ongoing assessments of credit quality of companies operating in specific industries such as insurance companies, banks and bank holding companies **[p. 3-4]**; in those cases, regulatory reports are commonly accepted to supplement creditors' understanding of GAAP statements **[p. 2-3, 5]**
  - For competitive and cost reasons; for example, when the company does not want to prepare GAAP statements and the creditor is comfortable with the lending decision **[p. 2-4]**
- When users accept OCBOA statements, they usually require additional disclosures in order to identify amounts accruable under GAAP but not recorded in the OCBOA statements **[p. 2, 4-6]**.

15. Priority of Improvements Needed in External Reporting

Note: The information presented below is based solely on the information set forth in section 15 of the database. In that regard, this information may supplement or, in some situations, conflict with users' needs expressed in other analyses of the database. section 15 of the database is comprised principally of the views expressed by users based on the material discussed at the March 11, 1993 meeting of the Creditor Discussion Group (14 participants) and the March 17, 1993 meeting of the Investor Discussion Group (6 participants). Furthermore, prior to discussing this topic with participants, the Subcommittee acknowledged that improvement of disaggregated disclosures was a top priority of users. Therefore, users were not requested to express their needs about disaggregated disclosures.

<u>Leading view</u>

The top three priorities, other than disaggregated disclosures, mentioned by investors were (in order of priority):

1. Developing a concept of core earnings
2a. * *Disclosure of measurement uncertainties*
2b. * *Consolidation practices and unconsolidated entities (considered one topic by some users)***
2c. * *Display of financial information*
2d. * *Disclosure of operating opportunities and risks***
2e. * *Business combination practices*
2f. * *Financial instruments and off-balance-sheet financing*

- Comments made by investors on these topics are discussed on pages **5-6** and **13-15** of the database. Specific comments include:
  - Need more explanations on the assumptions used to measure uncertainties **[p. 6]**
  - More disclosure is needed for finance subsidiaries of non-financial entities **[p. 13]**
  - A concept of core earnings is needed to allow users to better predict future cash flows for the entity **[p. 15]**

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*-- each category was selected by 2 participants.
**-- although not one of their top three priorities, two or more creditors also expressed a need for improvement in this area.

- Users need more information on asset and liability adjustments made by companies in accounting for a business combination **[p. 6, 14]**.

The top three priorities, other than disaggregated disclosures, mentioned by creditors were (in order of priority):

1. *Developing a concept of core earnings*
2. *Financial instruments and off-balance sheet financing*
3. *Display of financial information.*

- Core earnings is as important as disagreggated disclosures because it is a key element in the analysis process **[p. 7]**

- Core earnings allows users to estimate the future earnings of the company **[p. 8]**

- To better understand expected earnings **[p. 11]**, users will classify additional income statement items as unusual, nonrecurring, or infrequent **[p. 9]**

- Users need additional information about off-balance-sheet instruments (swaps, derivatives, futures, etc.) to better understand the operating risks of a company **[p. 8-9]**

- Users believe that practice is ahead of accounting for off-balance-sheet transactions **[p. 9]** and that senior management only broadly understands the related issues **[p. 10-11]**

- Users need consistency in the display of financial information to facilitate the analysis process **[p. 11-12]**.

Other areas of external reporting that users (both investors and creditors) believe need timely consideration for improvement include (need was expressed by 2 or more participants):

1. *Disclosure of nonbusiness information*
2. *Interim reporting*
3. *Auditor involvement*
4. *Alternative accounting procedures*
5. *Use of value information.*

- Comments made by users on these topics are discussed on pages **6, 9-12, 14-15** of the database. One of the comments made is that fair value information would be helpful if provided as supplemental disclosures **[p. 10]**.

16. Communication and Transmittal

16(a). Databases

Leading view

Users are increasingly using databases and will continue to use them mostly for screening purposes and to gain rapid access to aggregate industry information.

- Databases are useful to users because they provide easy access to considerable financial information for a large number of companies [p. 1-5, 7-14]

- However, their use is restricted mostly to screening purposes [p. 3, 5, 10, 12-15] and to accessing aggregate information [p. 5, 11-12, 14] because:

  - The information in the databases is not timely [10, 13, 15]

  - The information is not comprehensive; for example, footnotes to the financial statements are normally not included in the databases, which makes it more difficult to identify the differences in accounting practices among companies [p. 4, 7-8, 10, 13, 15]

  - Adjustments are made in the databases which are not easily identifiable and understandable [p. 3, 6, 13, 15].

Users have expressed a willingness to use databases in the future to assist them with their analytical work on specific companies as the information provided in databases becomes more comprehensive, consistent, reliable, and comparable.

- Some believe that further advances in database technology (for example, the EDGAR system), combined with improvements in financial reporting practices, will inevitably lead to an increase in the different uses of databases [p. 1-4, 10-11].

16(b). Other

Leading view

Timeliness of release of information by companies to users is one of the most critical and sought-after aspects of communication [p. 2-4].

17. Auditor Involvement

17(a). Benefits and criticisms of audits

<u>Leading view</u>

Users believe the value that auditors provide is directly related to their ability to be independent of management. Users have expressed concerns about current pressures on auditors' independence.

- The independence of auditors from management is clouded by their mutual business relationship **[p. 18, 21]**
- Pressure of maintaining a good business relationship with clients in a competitive environment could jeopardize auditors' independence **[p. 6, 11-12]**
- Auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements **[p. 13]**.

Users need audited financial information because it provides independent assurance of the reliability of amounts reported and disclosed in financial statements that are not otherwise verifiable by third-party users.

- Most users rely heavily on the fact that information used in their analysis has been verified by independent auditors **[p. 1-2, 17, 19]**
- Most users would be unwilling to lose the comfort of independence in the audit function **[p. 9]**. Independence gives users assurance that confirmation and verification procedures have been performed by knowledgeable individuals **[p. 9-10 17, 19]** that are not subject to management influence **[p. 9]**
- Auditors have access to financial information and other related data that is not available to third-party users of the financial statements **[p. 1]**
- Users rely on independent auditors to recommend needed improvements in the entity's control systems and to perform additional audit procedures in areas where material weaknesses are identified **[p. 10, 17, 20]**
- Auditor involvement in financial reporting provides a discipline for management to adhere to established accounting requirements **[section 17(d), p. 6-7]**

- The threat of litigation enhances the quality of the work performed by preparers of financial statements and their auditors, which, in turn, improves the reliability of the reported financial information **[p. 10-11, 15-17, 20]**.

Users are concerned about the credibility of an entity's reported financial information.

- Criticisms of preparers that also have implications on auditing include:

  - Users believe that preparers tend to disclose their company's performance in a manner that is most favorable to the company and, therefore, may not be indicative of actual results **[section 1(a), p. 1-2, 12]**

  - Preparers are willing to provide additional information about the "down-sides" of their companies when they are given an incentive. For instance, more disclosures would be made in a prospectus used to raise capital for the entity **[section 1(b), p. 78]**

  - Users believe that preparers have manipulated earnings in certain reporting periods by establishing reserves that could be used to adjust earnings in future periods **[p. 12-14, 18, 21, section 1(c), p. 43; section 1(d), p. 5]**

  - Frequent write-downs of assets and re-occurring restructuring charges have led users to believe that asset values have been overstated in prior audited financial statements **[p. 13, section 1(a), p. 50, 59]**, resulting in the loss of confidence in the integrity of such statements **[p. 7, 13, 14, 18, 21]**

  - To minimize the impact of increased costs of services that may result from additional accounting requirements, users are concerned that preparers would reduce the involvement of independent accountants. That is, preparers would have auditors perform reviews instead of audits or compilations instead of reviews **[p. 8, 15]**.

- Users' needs regarding areas of auditor improvement include:

  - Auditors need to better detect uncollectible receivables and/or overvalued inventory **[p. 18, 21]**

  - Auditors need to perform additional procedures to identify fraud or other errors in the financial statements **[p. 18, 21]**

  - Auditors need to challenge assertions and representations made by management about estimates and assumptions used in preparing financial information **[p. 5]**

- In evaluating whether reported asset and liabilities are fairly stated, auditors need to consider issues on a broad scale, such as context of the company within its industry and the nature of the markets in which the company operates **[p. 18, 21]**.

17(b). The scope of auditing

<u>*Leading view*</u>

Users need increased independent auditor involvement with regard to an entity's internal accounting controls.

- Reliability of the financial information provided to users would be improved if auditors were to comment on the adequacy of an entity's internal controls **[p. 3]**
- Users would like auditors to comment on the quality and effectiveness of an entity's system of internal controls **[section 17(c), p. 22, 23, 25-27, 30]**
- A critical aspect of an entity's accounting system relates to the control systems that are used to summarize and report transactions **[p. 9]**.

Users need increased auditor involvement with regard to an entity's compliance with laws and regulations **[section 17(c), p. 25]**.

Users do not need auditors to expand their audit scope to cover MD&A. MD&A should be prepared by individuals involved in operating the business.

- Involvement in MD&A is not an appropriate function of the auditor **[p. 3]** because auditors are not familiar with the nuances of the business **[section 17(c), p. 8]**. This information should be a discussion by management of the operations of the company **[p. 5-6]**
- Auditors involvement with MD&A may create a barrier that may result in management making less disclosures than currently made in MD&A **[p. 15-17; section 17 (c), p. 20, 28]**.

Users do not believe the scope of the audit function should be expanded to require auditors to render an opinion on forecasted or projected information prepared by management.

- Many auditors do not have the industry expertise that would enable them to express an opinion about forecasts prepared by management **[p. 4]**

- A forecast does not relate to historical information; therefore, the reasonableness of a forecast should be the responsibility of the analyst and not the auditor **[p. 5-8]**

- Auditor involvement with forecasted information would impair independence **[p. 6, 8]**.

Users did not express a need for auditor involvement in other sections of the annual report including:

- *description of business* **[p. 19-20]**
- *listing of properties* **[p. 19-20]**
- *discussion of legal proceedings* **[p. 19-20]**
- *president's letter* **[p. 19-20]**.

Alternative view

Users believe that auditors should be involved in opining on historical financial information included in MD&A.

- Some users would obtain additional comfort and faith in MD&A disclosures if auditors were required to audit factual financial information presented in the discussion **[p. 6, 15, 18, 20]**.

17(c). Audit reports

Leading view

Users believe that auditors should provide additional commentary in areas that would assist them in evaluating the quality of a company's earnings. Users want auditors to provide qualitative comments in the following areas:

- *audit scope and findings*
- *the entity's accounting and reporting practices in relation to other alternative accounting methods*
- *reasonabless 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.*

- Users rely on a standard audit report as a benchmark but believe that auditors should be allowed more flexibility in providing additional qualitative commentary that would be used for analysis purposes **[p. 2, 11, 15, 17, 21-22, 28-31]**

- By adding flexibility to their reporting, auditors would be allowed to provide users with an early warning about risks that may seriously impact the operations of the entity **[p. 11]**

- Auditor commentary should focus on the role of estimates in the financial statements and the sensitivity of these estimates to change **[p. 3, 7, 14]**. Auditor commentary on a company's significant estimates and internal controls would allow users to better assess the quality of earnings and to make their own estimates **[p. 4, 6-7, 21, 23]**

- Auditor commentary would have a greater impact if it were presented separately from the standard audit opinion and not included in a note to the financial statements **[p. 4-5, 14]**

- Today's reporting does not indicate the level of auditor involvement and related views with regard to critical or highly subjective areas (i.e. accounts receivable, inventories) **[p. 14-16]**. In this regard, auditors' reports should be expanded to discuss the scope and results of the auditors' work **[p. 21, 29]**

- Auditor reporting on an entity's compliance with laws and regulations would be considered helpful by users **[p. 25]**

- To be able to reach their own conclusions, users want the underlying assumptions used in the preparation of financial statements **[p. 13-14, 17]**.

<u>*Alternative view A*</u>

Users do not need auditors to provide additional commentary with regard to procedures performed and related findings.

- Users are concerned that supplementary comments would become boilerplate and, therefore, add no value to current auditor reporting **[p. 4, 16-18, 21-22]**

- A standard report, including any modification thereto, allows users to easily identify if an unusual matter or concern exists. Including supplementary comments may reduce users ability to assess if the auditor has any major concerns with the reporting entity **[p. 10, 23, 29, 31]**.

Alternative view B

Users believe that auditors should report on historical financial information included in MD&A.

- By implication with the alternative view expressed by users in **section 17(b)**.

17(d). Frequency of auditing

Leading view

Audits should be performed annually.

- Most users believe that annual audits are essential **[p. 2-3]** to provide users with periodic assurance that management is being disciplined to present financial information that is in compliance with GAAP **[p. 6-7]**

- Current competition in credit markets is such that if a substitute for annual auditing were sanctioned, creditors would find it difficult to require borrowers to incur the costs of annual audits **[p. 8]**

- Longer time periods between audits would make understanding an entity's business more difficult for users **[p. 6-7]** and may even increase an entity's cost of capital **[p. 4]**

- Current reporting alternatives are not adequate to provide disclosures and assurances investors need annually **[p. 6, 8]**.

17(e). Reviews

Leading view

Creditors accept reviewed financial statements (as defined under SSARS) from customers when risk is within an acceptance range but would like independent accountants to provide additional assurance on assets used as the company's borrowing base or that secure the borrowings.

- In many situations, creditors accept reviewed financial statements **[p. 1-3]** and supplement these statements with their own examinations and verifications **[p. 2-3]**

- Some creditors will require independent accountants to perform certain agreed-upon procedures when additional assurance is considered necessary **[p. 3]**.

Creditors have expressed concern about the quality of some reviewed financial statements.

- The quality of reviewed financial statements varies drastically. Some creditors have received reviewed statements without footnote disclosures **[p. 1]**, whereas others have received reviewed statements that are of a better quality than audited financial statements **[p. 3]**.

18. Structure and Process

18(a). International harmonization of standards

Leading view

Users favor the use of one set of accounting standards by all foreign companies wishing to raise capital in the United States, but only if it does not result in the loss of information currently disclosed under U.S. GAAP.

- A single set of accounting standards would enhance the comparability of information between domestic and foreign companies seeking capital in the U.S. markets **[p. 1, 10]**

- The current lack of comparability is an impediment to investment analysis and market efficiency **[p. 7]**; it is difficult and costly to analyze and reconcile information prepared on a foreign basis to an U.S. GAAP basis **[p. 9, 15, 19]**

- U.S. GAAP are more comprehensive than their foreign counterparts and are one reason why U.S. capital markets are efficient and attractive to foreign companies **[p. 5-6, 11-12, 16, 19]**

- Most users would not sacrifice the level and quality of reporting they get under U.S. GAAP for the sake of international comparability; they oppose a "lowering of standards" **[p. 1, 4, 7, 10, 14, 18-19]**

- Increasingly, foreign companies are voluntarily preparing their financial statements on a basis comparable to U.S. GAAP and this trend should continue **[p. 12-13]**

- Users are not opposed to changing U.S. GAAP to be more in line with an eventual international standard if it represents an improvement over existing GAAP **[p. 4, 15-19]**.

Alternative view A

Users are willing to accept financial statements prepared under a foreign basis other than U.S. GAAP for purposes of raising capital in the United States by a foreign company, as long as a reconciliation to some U.S. GAAP measurements is provided.

- Most foreign companies listed in the U.S. provide a reconciliation to some U.S. GAAP measurements and users believe that this should remain a minimum requirement for raising capital in the U.S. **[p. 3, 10-11, 14, 18-19]**

- Although most users would prefer that foreign companies prepare their financial statements using U.S. GAAP, they would settle for a reconciliation rather than denying those companies access to U.S. capital markets [p. 10, 18]

- Restricting access to U.S. capital markets for foreign companies would force U.S. investors to invest in foreign markets where they would get even less information disclosed by the foreign companies than what they would get under a reconciliation requirement [p. 12, 18].

<u>Alternative view B</u>

Users are willing to accept financial statements prepared under a foreign basis other than U.S. GAAP, without reconciliation, for purposes of raising capital <u>only</u> from U.S. institutional and other sophisticated investors.

- Some U.S. rules (for example, rule 144 A) already provide a precedent for foreign companies wishing to raise capital from limited U.S. sources [p. 11, 13]

- U.S. institutional and other sophisticated investors are better equiped to understand the risks involved with foreign investments and should be allowed to invest in foreign companies in the U.S. markets [p. 11, 13].

18(b). Impact of litigation

<u>Leading view</u>

A majority of users believe that a threat of litigation on managements and auditors is necessary and helpful.

- Users believe that a litigation threat has the following advantages:

  - The threat of litigation increases the quantity and the quality of auditors' work [p. 3, 7, 10, 12-14]

  - It promotes accountability by management and auditors [p. 1, 7, 13, 15]

  - It provides an incentive for auditors to maintain their independence [p. 2, 10]

  - It encourages management to make more conservative disclosures in external reports, which particularly appeals to creditors [p. 11-12, 14].

A slight majority of users believe that the current threat of litigation has a net beneficial effect on the quality of external financial reporting and of audits.

- Although most users believe that the current litigation threat, particularly in terms of number and size of awards, is excessive **[p. 3, 6, 10, 16]**, a slight majority of users also believe that the advantages of a litigation threat (listed above) still outweigh the disadavantages (listed below).

Alternative view

A strong minority of users believe that the current threat of litigation has a net detrimental effect on the quality of external financial reporting and of audits.

- In addition to their view that the current litigation threat is excessive **[p. 3, 6, 10, 16]**, users believe that the following disadvantages of the litigation threat outweigh the advantages:

  - The overall quality of external reporting is lessened by the inclusion of more boilerplate disclosures made strictly to avoid the threat of litigation **[p. 1, 10, 13, 15]**, and by management being less willing to disclose more positive information **[p. 6, 10, 13, 15]**

  - It significantly raises audit costs **[p. 3, 6, 10, 12-13, 15]**

  - It has a negative effect on business decisions made by various parties (managers, lenders, auditors) who are too concerned about potential liability **[p. 4-6, 11]**

  - Auditors are less willing to accept riskier types of audits **[p. 10, 13, 15]** and to extend their audit opinions to other parts of external reporting (such as the MD&A and more qualitative aspects of reporting) **[p. 8-9]**.

18(c). Resistance to change

Leading view

Preparers of external reports will be the group most likely to resist any change in external financial reporting.

- Reasons for preparers to oppose change include:

  - Costs to effect change **[p. 3]**

- A perception that more disclosure of information (which is normally the consequence of a change in external financial reporting) is against a company's competitive interest [p. 3, 5]

- Any additional external financial reporting requirement removes some of the flexibility preparers have in presenting and disclosing information in external financial reports [p. 4]

- Users will welcome change in external financial reporting if it represents an improvement in the quality of information disclosed [p. 4, 6-7]. Most users do not favor long transitional provisions for effecting change because they result in a loss of comparability of information for the same entity over time and among entities [p.5].

18(d). Investor and creditor involvement in setting accounting standards

Leading view

Users believe their historical lack of involvement in standards-setting activities mainly reflects limited resources, not lack of interest.

- Reasons given by users for their lack of participation in standards-setting activities include:

  - Lack of technical knowledge in accounting matters [p. 3-6]

  - Lack of time and resources compared to other constituents such as the preparer community [p. 3-5, 7]

  - Lack of direct communication with standards setters and of understanding of the standards-setting process [p. 1, 4-9]

  - Some users believe that their role is not to influence or determine the reporting rules, but rather to interpret the information they receive from external financial reports [p. 5-6]. They do not have as much of a "political" interest in the reporting rules as other constituents; their main concern is that everybody abides by the same rules [p. 4-5]

- Although acknowledging that their trade organizations are involved with standards-setting activities, users made a number of suggestions to incite additional user participation in standards-setting activities, including:

- User participation in field testing of new accounting proposals **[p. 1-2]**

- Nomination of a direct user as an FASB Board member **[p. 3]**

- Standards setters should initiate discussion and request written comments on accounting matters directly from specific users (identified in advance) **[p. 6-9]**.

18(e). FASB

Leading view

Users believe that the FASB structure is the appropriate structure to conduct standards-setting activities and that, overall, the FASB is doing a "good job."

- Although the FASB is doing a "good job" **[p. 2-3, 8-9, 17-78]**, users have some concerns about its structure and process, including:

  - FASB due process is too cumbersome and slow, which results in a lack of promptness in providing timely accounting rules and guidance **[p. 2-4, 7, 10, 45, 67, 71, 75-76]**

  - There should be more direct user input into the FASB structure and process **[p. 2, 12-15; refer also to section 18(d)]**

  - The FASB sometimes caters too much to the requests of the business community; this results in practical compromises such as delayed effective dates and long transition periods which are not desirable from an user perspective **[p. 5-6, 9]**.

19. Financial Instruments and Off-Balance-Sheet Financing

Leading view

More qualitative and quantitative information about the risks associated with financial instruments and off-balance-sheet financing arrangements should be disclosed in the notes to the financial statements.

- The majority of users agrees that there is a lack of relevant information in financial statements about the ever-increasing number of new financial instruments and off-balance-sheet arrangements, and that lack of information is an important impediment to their analysis work **[p. 1-14, 16]**. Some users believe that the current disclosure about some of the risks associated with financial instruments (contained mostly in FASB Statement No. 105) is inadequate and potentially misleading **[p. 4, 7-10, 16]**

- More qualitative and quantitative information about financial instruments and off-balance-sheet financing arrangements is needed to understand the nature of the various risks undertaken by a company **[p. 1, 3-13, 15-17]**. Suggestions of types of information needed include:

  - Hedging strategy **[p. 2-6, 8-12, 17]**

  - Sensitivity analysis based on changes in interest and foreign exchange rates **[p. 5, 7, 11, 17]**

  - More breakdown information on the risks related to derivative products (swaps, future contracts, etc.), particularly credit and counterparty risks **[p. 6-7, 10-12, 16, 18]**.

Alternative view

Together with improved disclosures, the development of accounting measurement rules (that is, for purposes of recognition in the body of the financial statements) for financial instruments and off-balance-sheet financing arrangements should be a priority.

- Accounting is not keeping up with all the innovation that is taking place in the area of financial instruments and off-balance-sheet financing **[p. 1-2, 5, 11, 15, 17]**. Of particular importance is the need to improve hedge accounting **[p. 4, 8-12]**.

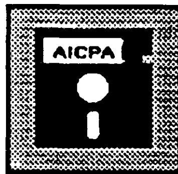
II Material From Documents Authored by Users or Based on Research Directly With Users

II Material Extracted From Documents Authored by Users or Based on Research Directly With Users About Their Needs for Information

The AICPA Special Committee

on Financial Reporting

Database of Materials on Users' Needs for Information



as of June 22, 1993

AICPA SPECIAL COMMITTEE ON FINANCIAL REPORTING
USERS' NEEDS SUBCOMMITTEE
DATABASE OF MATERIALS ON USERS' NEEDS FOR INFORMATION
AS OF JUNE 22, 1993
INTRODUCTION

Objective

The objective of this database is to organize what investors and creditors (users) have indicated about their needs for information in a manner that best facilitates subsequent analysis. In meeting that objective, we have followed certain guiding principles:

1. Capture all significant points from the direct documents, including users' rationale supporting conclusions and recommendations (each point is an extract).

2. Retain, to the extent possible, the original language from the source documents.

3. Include examples provided by users that illustrate points whenever possible.

4. Indicate the context from which each extract was obtained.

5. Indicate the source of each extract.

6. Organize the extracts into logical groupings and subgroupings.

7. Avoid staff analysis or explanation in the database. That analysis is the subject of a related but separate document titled "Analysis of the Information Needs of Investors and Creditors."

Sources of Information in the Database

The database includes material taken from certain direct documents. Direct documents are either authored by users, or based on research directly with users, about their needs for information. The Exhibit to this introduction indicates the direct documents that provided the information in this database.

Organization

This database is divided into categories and subcategories, which are listed in the index. We designed the organization to fit neatly into the work of the various Subcommittees of the Special Committee.

Format

The database includes three types of data: (i) extracts of direct documents, (ii) staff comments that help the reader place in context the related extract, and (iii) in rare cases, staff summaries of direct documents. The three types of data each appear differently in the database so that the reader can distinguish one from others.

Extracts are single spaced and slightly indented. Each paragraph of the extract is followed by a source reference, in bold type, indicating the document and page or paragraph number. Some extracts are included in more than one subcategory. If so, each paragraph of the extract is followed by a cross reference indicating the other subcategories where that paragraph is found.

Staff comments that help the reader place the extract in context are double spaced and not indented. The comments are preceded by **[Context]**, in bold type. Staff comments generally precede the related extract.

Staff summaries are double spaced and not indented. The summary is preceded by **[Summary of (give document and page reference here)]**, in bold type. Staff comments generally precede the related extract.

The Users' Needs Subcommittee

EXHIBIT

DIRECT DOCUMENTS
INCLUDED IN THE DATABASE

Direct Document	Code
1. SRI International, Investor Information Needs and the Annual Report, Financial Executives Research Foundation, 1987	SRI
2. The unpublished paper prepared by the Accounting Policy Committee of Robert Morris Associates, Summary of Important Positions Related to Accounting Principles and Auditing Standards, June 1990	RMA90
3. Letter from the Accounting Policies Committee of the Robert Morris Associates to Larry Grinstead dated September 16, 1992	RMA92
4. The Subcommittee's summary of transcripts taken from interviews with users and regulators performed by the FASB Oversight Committee of the Financial Accounting Foundation	FASOversight
5. Report of Association for Investment Management and Research Corporate Information Committee Including Evaluation of Corporate Financial Reporting in Selected Industries for the years 1989-90, AIMR, 1990	AIMR/CIC90
6. Reports of Association for Investment Management and Research Corporate Information Committee Including Evaluation of Corporate Financial Reporting in Selected Industries for the years 1990-91, AIMR, 1991	AIMR/CIC91
7. Report of Association for Investment Management and Research Corporate Information Committee Including Evaluation of Corporate Financial Reporting in Selected Industries for the year 1991-92, AIMR, 1992	AIMR/CIC92

DIRECT DOCUMENTS
INCLUDED IN THE DATABASE
(continued)

Direct Document	Code
8. The unpublished paper prepared by the Association for Investment Management and Research, dated April 3, 1991, Comments of Association for Investment Management and Research on Matters Addressed in Interview Guide of Oversight Committee, Financial Accounting Foundation	AIMR/FAF91
9. AIMR, The Financial Services Industry - Banks, Thrifts, insurance Companies, and Securities Firms, September 1992	AIMR FIN SER INDUSTRY
10. AIMR Position Paper, Financial Reporting in the 1990's and Beyond, AIMR, July, 1992	AIMR/FAPC 92
11. Lynch, Peter, One Up on Wall Street - How to Use What You Already Know to Make Money on Wall Street, Simon and Schuster, 1989	LYNCH
12. A study prepared for the Association of Reserve City Bankers by KPMG Peat Marwick, Estimating Fair Values for Financial Instruments - Disclosures and Beyond, Undated	KPMG BANK STUDY
13. Summary of the Subcommittee's discussions with several sell-side equity analysts from Bear Stearns	BEAR STEARNS
14. Summary of the Subcommittee's discussions with several sell-side equity analysts from Goldman Sachs	GOLDMAN
15. Summary of meeting with Jay H. Freedman, buy-side equity analyst, Lincoln Capital Management Company	FREEDMAN
16. Unpublished report to the Special Committee, A Content Analysis of Sell Side Financial Analyst Company Reports by Previts, Bricker, Young and Robinson, December, 1992	PREVITS
17. Hill and Knowlton, Inc., The Annual Report: A Question of Credibility - A Survey of Individual and Professional Investors, October, 1984	HILL KNOWLTON

DIRECT DOCUMENTS
INCLUDED IN THE DATABASE
(continued)

Direct Document	Code
18. Towers Perrin, FAS 106 and the Equity Markets: "Big Bang" - or Nonevent, October, 1992	TOWERS PERRIN
19. S & P's Corporate Finance Criteria, Standard and Poor's Corporation, Spring, 1992	S&P
20. Unpublished paper by Betriou, Ewenczyk, Meriaux, and Muller, Financial Analysts' Requirements in the Field of Accounting Data	BETRIOU
21. Letter from Jack Ciesielski, financial analyst, to Denny Beresford about user input in the standard setting process	R. G. Associates
22. Survey titled, A Study of the Attitudes Toward and an Assessment of the Financial Accounting Standards Board, conducted by Louis Harris and Associates, Inc., 1985	Harris
23. Materials resulting from the Subcommittee's Investor and Creditor Discussion Groups:	
a. Transcripts of the October 16, 1992 meeting of the Investor Discussion Group	TI 10/16
b. Postmeeting questionnaire October 16, 1992	PMQI 10/16
c. Transcript of the December 9, 1992 meeting of the Investor Discussion Group	TI 12/9
d. Postmeeting questionnaire December 9, 1992 and January 13, 1993	PMQI 12/9 and 1/13
e. Transcript of the January 13, 1993 meeting of the Investor Discussion Group	TI 1/13
f. Transcripts of the March 17, 1993 meeting of the Investor Discussion Group	TI 3/17
g. Postmeeting questionnaire March 17, 1993	PMQI 3/17

DIRECT DOCUMENTS
INCLUDED IN THE DATABASE
(continued)

	Direct Document	Code
h.	Transcripts of the December 8, 1992 meeting of the Creditor Discussion Group	TC 12/8
i.	Postmeeting questionnaire December 8, 1992	PMQC 12/8
j.	Transcript of the February 2, 1993 meeting of the Creditor Discussion Group	TC 2/2
k.	Postmeeting questionnaire February 2, 1992	PMQC 2/2
l.	Transcript of the March 11, 1993 meeting of the Creditor Discussion Group	TC 3/11
m.	Postmeeting questionnaire March 11, 1993	PMQC 3/11
n.	Transcript of the April 7, 1993 meeting of the Market Value Discussion Group	TMKT 4/07

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1. Objectives and Approaches of Users

Data Base Code		Data Base Code	
SRI	■	S&P	■
RMA90	■	BETRIOU	■
RMA92	■	R.G. ASSOCIATES	■
FASOversight	■	HARRIS	■
AIMR/CIC90	■	TI 10/16	■
AIMR/CIC91	□	PMQI 10/16	■
AIMR/CIC92	■	TI 12/9	□
AIMR/FAF91	■	PMQI 12/9 and 1/13	□
AIMR FIN SER INDUSTRY	■	TI 1/13	■
AIMR/FAPC92	■	TI 3/17	■
LYNCH	■	PMQI 3/17	□
KPMG BANK STUDY	■	TC 12/8	■
BEAR STEARNS	■	PMQC 12/8	■
GOLDMAN	■	TC 2/2	■
FREEDMAN	■	PMQC 2/2	□
PREVITS	■	TC 3/11	■
HILL KNOWLTON	■	PMQC 3/11	□
TOWERS PERRIN	■	TMKT 4/7	□

Database of Materials on Users' Needs for Information

1(a). Investors' and Creditors' Objectives and Approaches

Members of The Robert Morris Associates (RMA) are users of financial information, not issuers. As a user group, RMA's primary interest is that financial reporting be timely, complete, relevant, reliable and understandable. Accordingly, it focuses on the results obtained from financial accounting concepts and standards and from generally accepted auditing standards, rather than on the detailed procedures followed to obtain those results. Technical aspects of accounting are the responsibility of the accounting profession, being of less importance to users than is the information content of financial reports. **[RMA90, p. 1]**

RMA's views on accounting and financial reporting issues are from the financial statement users' perspective and, more particularly, from the perspective of those who lend or participate in the lending process. Lenders are primarily interested in assessing the ability of borrowers to repay debt. The first and preferred route is to be repaid from the cash flows of a going concern. The fallback source of cash is from the liquidation of the borrower's assets, either individually or in toto. In turn, lenders look for accounting information that allows them to assess the probable amounts and timing of their customers' future cash flows, as well as informing them of the assets available for liquidation and the nature of the queue of creditors with claims against those assets. **[RMA90, p. 1]**

The buy-side analysts surveyed followed an average of ninety-three corporations each and worked in firms averaging $7.2 billion in assets under management, distributed as follows:

- 21.5 percent—firms with less than $1.0 billion under management
- 60.7 percent—firms with $1.0 to $9.9 billion under management
- 17.8 percent—firms with $10.0 billion or more under management **[SRI, p. 13]**

Sell-side analysts are the securities analysts at broker/dealer institutions that serve both individual and institutional buyers and sellers of corporate securities. The sell-side analysts surveyed followed an average of forty-one corporations. **[SRI, p. 13]**

Brokers (registered representatives) are the professionals who deal directly with individual and institutional investors. The brokers surveyed were responsible for an average of 157 accounts or clients. Retail brokers averaged 208 clients, and institutional sales brokers averaged 105 accounts. **[SRI, p. 14]**

In general, the professionals are a skeptical group with a quantitative orientation to their work, an appetite for detail, and a distaste for what they perceive as exaggeration and incomplete disclosure. Their skepticism focuses mostly on the qualitative aspects of corporate information, especially on corporate disclosures and explanations of problems and poor performance. They have greater confidence in "the numbers," although even that feeling is tempered by the knowledge that, despite financial reporting standards established by such bodies as the SEC, the Financial Accounting Standards Board, and various industry regulators, corporate management still has great latitude in its selection of accounting rules, interpretations, cost and revenue allocations, and the like. **[SRI, p. 14]**

Specifically, the professionals believe that corporate managers naturally tend to disclose their company's performance in the most favorable light. Although they have confidence in management integrity, they state that managers commonly procrastinate in disclosing problems and that many managers express a more optimistic view of their company's situation that seems warranted by the professional's own analysis. Professionals have high praise for those companies whose executives do completely and candidly disclose their performance; in fact, many regard such disclosure as an indicator of the competence and self-confidence of the management group. **[SRI, p. 14]**

The professionals want as much first-hand information as possible, preferably from senior executives, especially the CEO. As one professional said, "I want to be able to see the CEO's eyes when he tells me about his company." Professionals are confident that they can detect exaggeration, incomplete disclosure, and misrepresentation (in the few instances when that occurs). They are equally confident in the ability of market forces to reveal the facts, although perhaps not quite so quickly. **[SRI, p. 14]**

Without exception, all analysts, portfolio managers, and brokers regularly review numerous sources of information—some to determine long-term performance of companies and their securities and some for up-to-the-minute monitoring of events affecting their investments. On average, the professionals surveyed examine twenty-five to fifty different types of information sources. When questioned on the need for such a variety of sources, they cited the following main reasons:

- No one, two, or three sources provide all the information needed to make a valid investment decision. **[SRI, p. 15]**
- Because every information source has its biases, a variety of sources must be reviewed to develop an objective view. **[SRI, p. 15]**
- A few sources provide basic and very important information; the other sources are used to confirm and enhance the information in these primary sources. **[SRI, p. 15]**
- Because so much of the available information is inexpensive, using a large number of sources is easy. **[SRI, p. 15]**

The sell-side analysts demand the most complete, objective information; the buy-side analysts and portfolio managers are only slightly less demanding, followed by the institutional sales brokers and the retail brokers. Brokers, however, rely heavily on the work of the sell-side analysts; their recommendations are thus based on high-quality information and analyses, even though they usually do not analyze the data themselves. **[SRI, p. 15]**

Except for some common techniques used to evaluate financial statements, the professionals analyze the plethora of available information in diverse ways. Some rely completely on quantitative data, others on qualitative information (company plans, reputation, market position, and the like), but most require both kinds of information to make decisions. A number of the more sophisticated analysts, and those with the necessary technical skills, have

invented their own analytical framework and algorithms; most employ some individualized theory in their analysis. Without exception, however, every professional admits that subjective or intuitive judgment significantly affects his or her investment decisions. **[SRI, p. 15 and 17]**

The larger investment firms tend to have elaborate procedures, involving several layers of managers and committees, for making and reviewing investment decisions. The smaller firms tend toward simpler, sometimes one-stop decision making. In some instances, the portfolio manager is also the principal analyst for a portion of the portfolio. Some firms establish specific criteria that must be met before a security can be bought or sold; others use ad hoc methods and rely on the decision maker's judgment applied in an unstructured way. **[SRI, p. 17]**

The most important part of the investment process, the purchase or sale of securities, is the simplest. For buy-side professionals, the approved purchases and sales are executed immediately or as part of a planned portfolio shift. For sell-side professionals, the process involves placing approved securities on a "recommended for purchase" list and then recommending these stocks to appropriate clients. **[SRI, p. 17]**

[U]nsophisticated [individual] investors actually consist of two distinct segments, which have been descriptively named "buy-and-hold" investors and "opportunity-driven" investors. The sophisticated individual investors have been designated as "semiprofessional" investors to differentiate them from the sophisticated professional investors whom the semiprofessionals resemble in some ways. **[SRI, p. 19]**

[Buy-and-hold individual investors] with only simple information needs, . . . draw on fewer sources of information than the other segments. Their decision-making process is primarily intuitive; their investment motivation tends to be security oriented, with a buy-and-hold philosophy dominating. **[SRI, p. 19 and 22]**

Opportunity-driven [individual] investors continually scan a wide variety of information sources so as to spot opportunities to improve their portfolios. Their investment decision making is not much more sophisticated than the buy-and-hold segment's, with an equally high dependence on intuition and information processed by experts such as analysts of brokers. Their basic investment philosophy is to increase their holdings and generate earnings. They are independent decision makers, relying on advisors for the information they provide more than for the advice they offer. **[SRI, p. 22]**

[S]emiprofessional investors are highly proactive in their investment activities. They have a trading mentality (averaging twenty-nine trades per year), meaning that they actively and continually monitor the market, seeking opportunities for short- and long-term gains as well as advantages created by price fluctuations. Their decisions are grounded in a good understanding of investment fundamentals, exposure to a broad array of information, and an appreciation for analysis (whether they buy it or do it themselves). **[SRI, p. 22]**

[A]bout half of the individual investors surveyed feel well-qualified to make their own investment decisions, but most do not consider themselves to be sophisticated investors.

Furthermore, all but a small number of investors actually do make their own investment decisions, with only about 15 percent of investors delegating that responsibility to others. The majority of investors are assisted by advisors, published investment information, or both. Only the more sophisticated investors feel qualified to make completely independent investment decisions. **[SRI, p. 22]**

The investment decision-making process of individual investors is far less precise than earlier studies have indicated. Even among the more sophisticated investors, subjective judgment, intuition, and "gut feel" are at least as important to the process as logical thinking and analysis. **[SRI, p. 24]**

[T]he great majority of individual investors base their investment decisions on little more than "impressions" and "intuition" resulting from the continual scanning of numerous sources of information and from contact with various people whose advice they sought. Only a small number followed a structured, analytical decision-making approach. Decision-making behavior correlates closely with the individual investor segments identified earlier; indeed, this was one of the elements used in defining the segments. **[SRI, p. 25]**

Individual investors use four general approaches to decision making: delegation, advisor dependency, informed intuition, and analysis. **[SRI, p. 25]**

Variety is the word that best characterizes the information sources used by investors. Individual investors, in aggregate, say they use thirty-nine different types of information sources, while professionals say they use fifty-seven different types. Why so many? No single source contains all the information investors feel they need to be well informed. They also want to compare information presented in several sources to help eliminate biases and to obtain various interpretations of the same data. [The following two] tables show the sources most used by individual investors and professionals:

- Sources of Investment Information for Individual Investors

Rank	*Source*	*Percent Using*
1	Company annual reports	59.3%
2	General newspapers	49.3
3	Wall Street Journal	41.5
4	My broker	28.2
5	General business publications	27.4
6	Personal contacts	26.1
7	Company quarterly reports	20.8
8	SEC filings and prospectus	14.9
9	Investment information services	14.7
10	Brokerage firm analysis/reports	13.0
11	Trade association/publications	7.1
12	My investment advisor	6.6
13	Television	5.7
14	Company press releases	5.4
15	Investment letters	4.5
16	SEC Form 10K	3.6
17	Proxy statement	2.8
18	SEC Form 10Q	2.8
19	Shareholder meetings	2.0
20	Radio	1.2

Note: Other sources with less than 1.0 percent usage were product brochures, company employees, company officers, investor relations programs, company advertising, computer data services, accountants, personal research efforts, attorneys, bank officers, financial planners, and libraries.

Source: SRI International survey, 1986.

[Also included in 1(b)] **[SRI, p. 33]**

- Sources of Investment Information for Professional Investors

Rank	*Source*	*Percent Using*
1	Company annual reports	84.6%
2	SEC Form 10K	62.2
3	Company quarterly reports	57.4
4	Other analysts or professionals	54.8
5	Company management	53.8
6	Investment information services	47.1
7	SEC Form 10Q	44.2
8	Company press releases	42.6
9	General business publications	37.2
10	General newspapers	34.0
11	Wall Street Journal	32.1
12	Trade associations/publications	26.6
13	Company fact books	17.6
14	Personal contacts	17.6
15	Analyst meetings/presentations	16.0
16	SEC filings/prospectus	12.8
17	Other analysts in my own firm	12.5
18	Investment letters	11.2
19	Company competitors	10.3
20	Proxy statements	9.6
21	Wire services	6.4
22	Company customers	5.1
23	Government reports/publications	4.8
24	Company suppliers	3.2

Note: All other sources had no more than 1.6 percent usage and included speeches and interviews of company officers, product literature, rumors, employee publications, Quotron, industry seminars, shareholders, credit reports, and former employees.
Source: SRI International survey, 1986.
[Also included in 1(b)] **[SRI, p. 34]**

Some [sell-side analysts] use . . . contrarian logic, which has been empirically refuted. For example Solt and Statman [1988] showed the futility of the Bearish Sentiment Indicator. Yet contrarian analysts survive. **[PREVITS, p. 11]**

[Sell-side] analysts use a combination of fundamental techniques in developing a recommendation on a company. Fundamental analysis is used to forecast performance and assess condition. Technical analysis is used most frequently to predict the movement of a company's stock price, given the results of the fundamental analysis. **[PREVITS, p. 11]**

Most sell-side analysts recommendations fit into three general categories: buy, sell, and hold. Buy recommendations predominate. Sell recommendations are extremely rare. According to Zacks Investment Research, recent recommendations were 50% buy, 42.5% hold, and 7.5% sell. . . . **[PREVITS, p. 11]**

There are several plausible explanations for this [sell recommendation] distribution. First, brokerage firms earn commissions through selling securities, and need to identify undervalued securities to promote. Similarly, brokers that manage a public offering of a company's have incentives to issue buy recommendations. The rarity of sell recommendations may be attributed to the heavy reliance that sell-side analysts place on management sources for company information. Analysts seem to be concerned that management will become less available and forthcoming if "sell" recommendations are made. **[PREVITS, p. 11]**

Recent press reports allege that difficulties [relating to a heavy "buy" climate] exist at major brokerage and investment houses [e.g. Morgan Stanley; Kidder, Pea body] and concern major stock [e.g. Dell Computer; Microsoft]. **[PREVITS, p. 11]**

[S]ell-side analysts may be more subtle in their signaling. There are a variety of types of buy and hold recommendations, and analysts may qualify their recommendation in the text of the report. This provides the basis for a relative ranking of companies such that, given that investor resources are not unlimited, weak hold recommendations can be viewed as sell signals. A few analysts reports are more general evaluations that do not contain specific recommendations. [Also included in 1(c)] **[PREVITS, p. 11-12]**

In assessing individual company's performance over time, analysts speak of "easy" and "hard" earnings comparisons with earlier equivalents periods. Analysts show awareness of earnings management, for example in commenting on the easy earnings comparison of a company occasioned by a "big bath" taken in the year earlier period. They are particularly interested in identifying company trends and changes affecting company trends. Directional phrases such as "change(s)", "increase", "decrease", "decline", "new", and so forth, occur thousands of times in the full sample [of the study]. [Also included in 1(c)] **[PREVITS, p. 12]**

[Sell-side] analysts often organize their reports so as to provide information that supports their EPS forecasts but also provide a list of "risks" or "concerns" that could negatively affect a company's performance. Corporate auditors are identified or commented upon infrequently [in analysts reports], however in one instance a change in auditors was listed as a "risk factor" [Also included in 1(c), 10(d), and partly included in 17(f)] **[PREVITS, p. 12]**

A standard, if somewhat simplified, approach taken by most analysts in forming recommendations is as follows. Disaggregate the company's operations into as fine a set of operating units as possible and develop earnings forecasts for each unit. This reduction is much finer than GAAP. For example one report commented that a company "reports two lines, but there are actually three". Analysts regularly discuss the above matters with respect to each operating unit. For example, one waste removal company was analyzed by individual landfills; a gaming company was analyzed by individual casinos, etc. [Also included in 1(b), 1(c), and 3(e)] **[PREVITS, p. 12]**

[A]nalysts employ "common size" financial report formats repeatedly. The technique used is to present each key element of the balance sheet and income statement for comparative periods in percent terms of a key number of the statement so sized such as total assets or net revenues. **[PREVITS, p. 13]**

[Equity sell-side] analysts distinguish between valuations based upon the company's continued existence in its present form: so called fundamental value, and valuations based upon acquisition or breakup of the company. Analysts use several approaches to valuing companies based on fundamentals, most typically in terms of the present value of the company's cash flows, its earnings, or balance sheet valuations. In this approach analysts also distinguish between a company's "Public market value" and "private market value". For example, one analysts measures the fundamental value of a company in terms of:

1) Private market value
2) Price/revenues
3) Price/book value
4) Price/long-term earnings
5) Growth-driven valuation composite
6) Contrarian composite [e.g. Bearish Sentiment Indicators]
7) Earnings momentum composite
8) Technical ranking
9) Beta

[Also included in 1(b), 1(c), and 4] **[PREVITS, p. 19]**

[One] analyst valued companies in terms of revenue, cash flow multiples, and net income. And yet another analyst valued a cable TV company with purported off-balance-sheet assets on three basis:

1) present value of cash flows,
2) appraised value of assets and
3) the company's liquidation value.

[Also included in 1(b), 1(c), and 4] **[PREVITS, p. 19]**

Another analyst evaluated the same cable TV company by analyzing each of the many limited partnerships with which the company was related in order to estimate the long-range cash flows of each to the company. [Also included in 1(b), 1(c), and 4] **[PREVITS, p. 19]**

Analysts label valuations of a company based upon it acquisition or breakup as it "buyout value", "breakup value", "takeover value", "theoretical breakup value", and so forth. Examples of computed break up value include the following:

1) Estimated breakup value = asset values at market price less liabilities.
2) Adjusted breakup value takes the above and adds other "likely" assets.
3) Possible breakup value adds other "possible" assets to all of the above.

[Also included in 1(b), 1(c), and 4] **[PREVITS, p. 19]**

[The] content analysis of [the] word usage by sell-side equity analysts and bond rating analysts suggest that traditional statement content plays an important but incomplete role in developing analysts reports. Each group emphasizes different statements. Equity analysts are

income/performance driven and debt analysts are balance sheet/leverage driven. **[PREVITS, p. 21]**

The needs of analysts go beyond the historical cost, transaction matching model of traditional statement based reports. Equity analysts provide softer, more frequent and more comprehensive details using subjective interpretations from a collection of micro and macro information so as to construct scenarios of likely alternative prospects of the company. [Also included in 13] **[PREVITS, p. 21]**

As such traditional statements fulfill their expected role of providing historical perspective useful to analysts interested in developing outlooks based on an objectively reviewed performance report, conservatively stated. [Also included in 13] **[PREVITS, p. 21]**

To the extent that earnings, earnings momentum and earnings potential drive the equity analytics of sell-side reports, the need for more frequent than annual information on performance is clear, as is the need for more finely disaggregated performance information, in common sized formats to enhance intercompany comparisons. [Also included in 2(c), 3(c), 3(d), and 11(a)] **[PREVITS, p. 21]**

The merit of additional cash flow ratio analysis reporting . . . seems worth examination. **[PREVITS, p. 21]**

The Association for Investment Management and Research (AIMR) was formed through a merger of the Institute of Chartered Financial Analysts (ICFA), founded in 1962, and the Financial Analysts Federation (FAF), founded in 1947. . . .**[AIMR/FAPC92, p. 1]**

AIMR members are investment management professionals. Membership includes securities analysts, portfolio managers, strategists, consultants, and other investment specialists. Members practice in fields such as investment counseling and management, banking, insurance, investment banking and brokerage. Of AIMR's 22,581 members, 14,513 (64%) hold the designation Chartered Financial Analyst (CFA) in recognition of their accomplishment in passing all of the three CFA examination parts. Seventy-one percent of AIMR members hold degrees beyond the baccalaureate. Eighty-six percent are located in the United States, ten percent in Canada and the remainder in other countries. **[AIMR/FAPC92, p. 1]**

Investment management professionals often are categorized by activity into what are called "buy-side" analysts and "sell-side" analysts. The latter are likely to be employed in the research departments of investment banking and brokerage firms. Their reports tend to focus on individual companies and in larger firms they specialize by industry. The work of buy-side analysts is less often seen because it is usually produced for confidential use by the analyst's employer, more often than not a portfolio manager or investment counselor. [Note added by staff--According to Committee members at a meeting with FASB, March 12, 1993, membership of AIMR is about 50 percent buy-side analysts, and their proportion is growing.] **[AIMR/FAPC92, p. 1]**

In addition to analysts employed in the securities industry broadly defined, AIMR members engage in an impressive range of other employments. There are many analysts employed by business and consulting firms who are engaged in competitive analysis, the appraisal of competitors within their industry, and analysis of potential acquisitions. There are analyst specialists, such as those who concentrate on accounting issues or other technical support areas within a financial firm's research department. A small number of AIMR members are academics. **[AIMR/FAPC92, p. 1]**

A recent survey by AIMR's Financial Accounting Policy Committee (FAPC) showed that virtually all of these investment professionals used financial reports in their work either directly or indirectly. Several of them utilize financial information accumulated in and accessed through databases. At the other extreme, many of them read volumes of financial statements in complete detail. Others fall in between and may combine the use of databases with reading financial reports in detail on a selective basis. **[AIMR/FAPC92, p. 1]**

. . . Many of AIMR's advocacy efforts are expended in the realm of financial reporting and corporate information. The AIMR Corporate Information Committee (CIC) each year publishes a report that evaluates the quality of corporate financial reporting in selected industries and makes awards for excellence. **[AIMR/FAPC92, p. 2]**

The Financial Accounting Policy Committee (FAPC) maintains contact with both private and public sector accounting groups that establish accounting standards to assure that the needs of investors are communicated and included as standards are promulgated. . . .**[AIMR/FAPC92, p. 2]**

This report continues the tradition of occasional position papers by the Financial Accounting Policy Committee. As such, it presents the views of the largest and most important organized group of financial statement users in our economy and in the world. **[AIMR/FAPC92, p. 2]**

In recent months both the American Institute of Certified Public Accountants (AICPA) and the Financial Executives Institute (FEI), the groups representing, respectively, the main bodies of auditors and preparers of financial statements, have begun work on major projects to study financial reporting. In 1991, the Financial Accounting Foundation, the parent and sponsor of the FASB, formed an oversight committee of its board of directors to evaluate the operations and product of the FASB. Thus, in the financial reporting milieu, the standard-setting body, preparers of financial statements, and auditors all are in the process of presenting their views to the world. AIMR, as the primary organization representing financial statement users, needs to be heard at least as clearly and resoundingly as other groups involved with financial reporting. **[AIMR/FAPC92, p. 3]**

In the past FAPC position papers have been addressed to groups responsible in some way for accounting standards setting. This report seeks a broader audience. Its primary purpose is to influence the opinions and actions of: (a) managements of the companies that prepare and issue financial reports; (b) accounting standard setters and securities markets regulators, who set the parameters within which those reports must fall; and (c) independent auditors, who attest to the

> fairness of those reports. The over-riding message to each of those groups is that the purpose of external financial reporting is to serve the needs of those who use it. **[AIMR/FAPC92, p. 3]**
>
> This report also is one of the initial major policy initiatives since the formation of AIMR. Previous works of its predecessor bodies, the Financial Analysts Federation and the Institute of Chartered Financial Analysts, represented the views of their separate constituencies. Now, we have the opportunity to produce the first of what we hope will be a series of policy statements and reports that will present the collective views all securities analysts and other investment professionals. **[AIMR/FAPC92, p. 3]**

[Context] The AIMR position paper, *Financial Reporting in the 1990's and Beyond*, comprises 72 pages on a variety of subjects that are pertinent to the work of the Special Committee on Financial Reporting. Most of the 19 categories in the Special Committee's database include excerpts from it, usually introduced by a paragraph or two from its "Executive Summary" (pages vi-x).

The position paper provides the following summary of the section (pages 6-11) entitled "Financial Analysis and Financial Reporting":

> This section provides primarily descriptive information. It discusses the interrelationship between the efficient market hypothesis (EMH) and other theories of financial economics and the role of financial analysis in making markets efficient. It presents a description of the analytic process to the extent that generalizations can be made in that area. It lists and describes the vast variety of information sources used by analysts, of which financial reports are an indispensable part of the whole. It then describes in more detail each of the financial reports analysts rely on in their work. [Also included in 1(b) and 1(c)] **[AIMR/FAPC92, p. vi]**
>
> One of the most important points made in this section is defining the distinction between financial analysis and financial reporting. We believe that financial reporting should be concerned with presenting the economic history of specific economic entities and that it is best done when managements also are willing to disclose and discuss their strategies, proposed tactics and plans, and their expected outcomes. Forecasts of the future and similar material enhances financial report usefulness, but must be separated from and not confused with the financial statements themselves. The function of analysis is to allow those who participate in the financial markets to form their own rational expectations about future economic events, in particular the amounts, timing and uncertainty of an enterprise's future cash flows. Through this process, analysts form opinions about the absolute and relative value of individual companies, make investment decisions or cause them to be made, and thereby contribute to the economically efficient allocation of capital and clearing of the capital markets. [Also included in 1(b) and 1(c)] **[AIMR/FAPC92, p. vi]**

[Context] Those two paragraphs introduce the following excerpts and relate them to excerpts from the same section included in 1(b)-Types of information that investors and creditors use. . . and 1(c)-Investors' and creditors' use of information to achieve their objectives.

The Nature and Role of Efficient Markets

Over the past twenty-five years or so, a great literature has been created that supports the hypothesis that financial markets are, to one degree or another, efficient. How efficient is a matter of debate among both practitioners and academics even today. In its most basic form, the efficient market hypothesis (EMH) states that information is quickly impounded in stock prices. The implications are that one cannot profit by having access to information that also is available to others. The evidence supporting the EMH is voluminous in the literatures of economics, finance and accounting. There also is abundant literature that points out anomalies in the EMH. The degree to which market efficiency actually exists is a matter that will continue to be debated for some time to come. **[AIMR/FAPC92, p. 4]**

What we all may agree upon is that information does affect stock prices eventually. The corollary is that markets could not possibly be efficient if information were not available. In addition, those who either lack information or who do not understand the information that is available to all are at a distinct disadvantage in buying or selling securities. Therefore, no matter how efficient or inefficient a financial market may be in fact, information is its lifeblood. **[AIMR/FAPC92, p. 4]**

Financial information comes from many sources and in many forms. Much of it is received by financial analysts prior to the issuance of financial reports. The news wires are filled with items giving information about major events affecting various companies: new contracts, new financing, legal actions, product introductions, patent grants, capital spending plans, personnel changes, and the like. Companies send out press releases, hold analyst meetings, and otherwise see that news affecting them is presented in its most favorable light. Much of the information that moves the market is qualitative in nature and requires subsequent verification. It is used by analysts to form estimates of future earnings and cash flows and to draw conclusions as to whether a particular company's securities should be bought, held or sold. **[AIMR/FAPC92, p. 4]**

Financial statements and other formal financial reports are usually produced some time after the fact. They provide analysts the assurance that their initial interpretations of company news were sensible and to some degree accurate. Sometimes it is asserted that financial statements do not contain news, i.e. new information. Analysts hope that assertion is true. If it is, that means that both the companies and the analysts that follow them have done their jobs successfully in making the market as efficient as can be. When a financial statement contains one or more "surprises" that cause a market price to change, one usually may conclude either that the analysts lacked perspicacity or that the company engaged in duplicity. **[AIMR/FAPC92, p. 4]**

Although a financial report may not contain "news," that does not mean that it does not contain information. Later in this report, we point out the many ways in which such reports provide not only a record of the past, but also clues to the future and a myriad of detailed data not available elsewhere. The overriding mission of this report is to discuss in detail exactly how that information should be presented so as to be of the optimal use to financial analysts and, in turn, to the efficiency of capital markets. **[AIMR/FAPC92, p. 4]**

Analysts Look for Anomalies Between Price and Value

The function of markets is to set prices and effect transactions. The function of financial analysis is to assess values. If markets were truly efficient, price would adjust quickly to value as information became available and its implications were understood. However, even in the most efficient of markets, different people assess value differently. The dividend discount model (DDM) valuation framework is often used to estimate the worth of a security as the present value of its future dividends plus its residual price discounted at a risk-adjusted rate of return. The capital asset pricing model (CAPM) provides an analytical framework to relate expected return and risk. However, tolerance of risk varies among individuals, as do estimates of the amounts, timing and uncertainty of future dividends. A market price is at the margin: persons who continue to hold securities believe them to be worth at least their market price; and to be appropriate to the portfolio. **[AIMR/FAPC92, p. 5]**

Financial analysts look for market price anomalies, securities whose values are perceived to be different from their current market prices, usually greater but sometimes less. In doing so, analysts form projections of future earnings, usually as a surrogate for estimating future cash flows. Major events in the economic life of a company may cause analysts to reassess the company's future earnings and may in turn be reflected through significant changes in the market price of the company's securities. Analysts' reports are used by securities firms to make buy, sell or hold recommendations. Portfolio managers and other investors actually make buy-sell-hold decisions. As investors change their minds about the values of individual securities, they change their portfolios accordingly. Thus, capital is allocated efficiently and impersonally to its best use in the economy. **[AIMR/FAPC92, p. 5]**

Financial analysts also participate in due diligence proceedings, advising deal makers and investors as to the economic values underlying proposed transactions. Other analysts prepare valuation studies to assess competition and competitors. Others are consultants on valuation. In sum, if markets are efficient, they are made so by the work of financial analysts who continually are seeking to find discrepancies between price and value, and who advise on portfolio transactions accordingly. This moves market prices toward price-value equilibrium. **[AIMR/FAPC92, p. 5]**

Growth in the Size of Institutional Ownership of Securities

Ever since World War II the proportion of securities, particularly common stock, owned by institutions has grown continuously. At the end of September, 1991, only 54.5% of total equities were held by households, down from 91.3% in 1950. The rest are held by mutual funds, pension plans, philanthropic and educational organizations, etc. The rise of institutional ownership is subject matter for a different report than this, but it does have two distinct implications for financial analysis. **[AIMR/FAPC92, p. 19]**

As the proportions of shares owned by institutions increases, so does their proportional ownership of individual companies. In fact, some ownership interests are so large that the institution cannot make meaningful changes in its portfolio without consequential effects on the market price of the shares being traded. The sheer size of some fund groups, such as the California Public Employees Retirement System (CALPERS), makes it difficult to have investment aspirations beyond matching the movement of the markets as a whole. To such large institutions careful evaluation and analysis of the financial reports of individual companies may not always be a useful activity because it is economically infeasible to act upon it. **[AIMR/FAPC92, p. 19]**

However, it is only the truly mammoth funds that are precluded from achieving consistent above-average returns. As a counter example we offer the case of the Fidelity Magellan Fund which, under the management of Peter Lynch, realized consistent above-average returns year after year, despite being one of the largest mutual funds in the world. Other successful funds, such as Vanguard's Windsor Fund, have stopped or suspended accepting new investors in order to preserve the flexibility they need to act in the market. In those cases, the principal reason for the fund's success is the careful screening and evaluation of individual companies. **[AIMR/FAPC92, p. 19]**

A second notable implication of the rise of institutional investors is the increased need for financial reports written for and directed to the professionals who actually select or otherwise recommend the securities owned by institutions. Individual investors no longer should be considered the primary target audience for financial reports. It would be scandalous to deprive professional investment advisors, portfolio managers, and other financial analysts of information they need on the flimsy grounds that those data might confuse individuals who do not understand accounting. After all, those who profess to use financial reports bear some responsibility to educate themselves on how to read them. **[AIMR/FAPC92, p. 19-20]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. Participants were presented with a description of five basic categories of objectives and approaches that investors use: the cross-sectional approach, the fundamental analysis approach, the anticipation approach, the technical approaches, and the combination approaches. With respect to those categories, they were asked three questions:

- What is their objective and approach to evaluating equity securities?
- Is the list of objectives and approaches accurate?
- What is the relative popularity of the various objectives and approaches among sophisticated investors?

Participant I-8

My approach is the fundamental analysis approach. My approach is to try to find companies where there was a period of significant growth and the company was viewed as a growth company. The company sold at a high valuation, something went wrong; the value or the price of the stock is down very substantially. The things I'm looking for are whether the stock is cheap on every basis. The objective that I'm looking for is a very substantial capital appreciation if I'm right and the company resume some growth pattern. **[TI 10/16, p. 2-3]**

Participant I-6
As a fundamental analyst, I try to forecast earnings. In order to forecast earnings, you have to have a basic understanding of what the company is doing and how it does it. That includes an understanding of the product and the market for the product and, basically, when you look at financial reports, the only thing they tell you is a bunch of numbers that are financial related, but it would help if we knew what the quantity was of what the company produces. There is also a lack of compliance with FAS 14 on segment disclosures. So when we try to forecast earnings and we don't know the quantity of products the company produces, it's very hard to really forecast those earnings. [Also included in 3(a) and 13] **[TI 10/16, p. 3]**

Participant I-7
Within our organization, there are probably 100 analysts. For the most part, we are very industry specific. [Participant I-6] will follow metal companies, I will follow electrical equipment companies, such as [names deleted] and the likes. One of my primary functions is to directly influence the buy, hold, sell investment decision-making policies on companies in my industry. Within that context, if I had to focus on one single element that is extremely crucial, it's earnings. I also agree with [participant I-6], there is a FAS 14 on the books which for the most part is useless. Either the companies are dismissing it or using it to show how they would like to be viewed from an external point of view, but I would like to see a company the way it looks at itself from an internal point of view. Most of the FASB presentations absolutely don't do that. [Also included in 3(a)] **[TI 10/16, p. 3]**

Participant I-12
I am a fundamental analyst and I cover a wide range of industries. Basically, an analyst's job is to forecast future cash flows and future cash flows often bear no resemblance to reported earnings. The reason for that is that a dollar in your hand is not necessarily a dollar that the accountants recognize. What we analysts have to do is to take the basic financial statements and attempt to find out how much of that is cash and how much is not cash, but rather an accounting convention. Over the years, as the accounting profession tried to keep up with the innovations, they made some determinations about how those transactions should be recorded and, in some cases, those determinations further hide the real cash flows of the company. I think, for example, in terms of present value accounting issues where companies are given enormous latitude in some respects. **[TI 10/16, p. 3-4]**

Segment reporting is something that is absolutely critical to an analyst. For example, for [a large, diverse financial institution], the cash flows generated by the credit card business have entirely different sources and uses than the cash flows generated by the securities business. It's very difficult from what we see to find that out and find a base from which we can forecast. [Also included in 3(a) and 3(b)] **[TI 10/16, p. 4]**

Participant I-1
A pure quantitative approach has been left out. A quantitative approach would not necessarily be concerned with what the company does; they're relying more than the fundamentalists on the data that is generated by historical financial statements. **[TI 10/16, p. 4]**

Under the fundamental approach, you are overlaying more judgment to the numbers. So you are concerned with the markets, the customers, the critical variables, all the things you don't generally get from financial reporting. I find historical financial statements to be virtually worthless as a fundamental analyst. I could virtually not have the front part of the financials if you put notes disclosing significant litigation, asbestos liability, unfunded pensions plans: that is probably the most I get out of the historical statements. You have to start some place, but I'm not sure that gets you too far. [Also included in 1(b)] **[TI 10/16, p. 4-5]**

Participant I-4
I think historical numbers are necessary but not sufficient to do fundamental work. The people here from the investment field are probably all fundamentalists. We do special situation work, we are trying to determine what is the real corporate value of companies which we are analyzing or buying. We attempt to analyse cash flows and/or redundant assets, and then putting some kind of capitalization rate on that growth. So it is important for us to look at what we think is real generation of cash flows; for that, you need historical data but also a lot of judgment work. Once we determine what value is, we attempt to find whether the company agrees with us in realizing value. A lot of the value comes out because corporate activity occurs, not because the stock market goes up or down, but because someone internally realizes that values in a real world are substantially higher over time than what the price is in the marketplace. [Also included in 1(b) and 1(c)] **[TI 10/16, p. 5]**

Participant I-9
We have about $20 billion under management and a research department of about 7 or 8 people. It used to be that an institution of that size would have about 30 analysts; those days are over. Which means that the job of the financial reporting community has become more important; the analysts cannot know the industries in the same depth they did before. We never make an investment unless we have audited financial statements of the company and we don't make an investment unless we meet the management of the company. Our approach is fundamental; the valuation starts with the financial statements and then our projections going forward, based on what management tells me and what we see in the trends of the company. The other aspects are psychology and momentum; the accounting profession cannot help us with that. Sometimes, we rely heavily on the information provided in financial statements, at other times that's not what is going to lead us to make the right investment decision. [Also included in 1(b) and 1(c)] **[TI 10/16, p. 5-6]**

Participant I-2
Other approaches include the momentum approach, which is an effort to track changes in opinion when earnings are consistently cut, for example; if you have one earnings cut, you probably will have two or three. That's an example of the momentum approach. There is also the black box approach, used by a number of major institutions, which is a combination of momentum, screens, price to book, etc. You put the numbers in and you get a ranking out. You also have the sector weight approach, used by some major institutions to manage their

funds, where you put more weigth on favorable sectors and less on unfavorable ones. It is a subtle way to hedge your bet without getting too far off the indexes. **[TI 10/16, p. 6]**

Your client base in accounting is dealing with a dynamic system, not only with changes in the economy, but also the secular changes. For example, the accounting opinion on inflation years ago; it turns out it was so difficult that it ended up not being terribly useful. For the last five or six years, we're seeing companies doing things we never thought they could: massive layoffs, wage givebacks, etc. As a fundamental analyst, you need the ability to get inside the company and understand what makes it tick. So you want to understand sources of cash flow and how the business works (and that on a quarterly basis). What if scenarios are very important to us; we need the detailed information to do those "what if" exercises because it is a very important element of our job. [Also partly included in 1(b)] **[TI 10/16, p. 6-7]**

Committee/Staff/Observer
The second question relates to only the fundamental approach to investment. The meeting materials identified 5 methods of determining the intrinsic value of a security or a company:

- Apply a multiple to predicted earnings
- Discount predicted cash flows
- Discount predictions of future dividends
- Discount predicted earnings
- Or some combination of the four or some other approaches as well. **[TI 10/16, p. 7]**

The question is: How do investors determine the intrinsic value of an equity security and the underlying company? Please try to touch on some details for us like: how far into the future do you predict cash flows, earnings, dividends? **[TI 10/16, p. 7]**

Participant I-10
We all know we are severely limited on how far we can look into the future. When you visit companies and go through their own plans and their own views of themselves, you normally get 3, 4, 5 year plans; to some extent, we are tied to that time period. Studies have shown that if you can project earnings for a period of five years, you are way ahead of most stock pickers and you will do very well with no other information. So, something like 3 to 5 years is probably reasonable for what we are trying to do. Sometimes, you are more secure in your 5 or 3 year projection than you are in your 1 year projection. We are in the business of making judgments about where earnings are likely to be in the next number of years, and the quality of those earnings. It is a very complicated process and I would guess that we are not making projections for 10 or 20 years. [Also included in 1(c)] **[TI 10/16, p. 7-8]**

Participant I-8
Earnings is the starting point. But there is another layer which is the external setting (how the company is perceived). [Also included in 1(b)] **[TI 10/16, p. 8]**

Participant I-7
As far of our organization is concerned, we are required to have an estimate for the current quarter, the current year, the following year, and a percentage number for the subsequent five years. [Also included in 1(c)] **[TI 10/16, p. 8]**

Participant I-6
Earnings are the common denominator, much more than cash flow. But I don't want to dismiss the importance of cash flow. You can't forecast cash flow without forecasting earnings. For an analyst, some industries' cash flow is much more critical than earnings. Other industries' cash flow is important but that's not the common denominator. In the marketplace, most people talk about P/E ratio, not cash flow multiples. And in many of the discussions with portfolio managers who focused on cash flow, not more than half a dozen agree on the definition of cash flow. Until we get a standardized definition of cash flow, we are deceiving ourselves in some respect to say that we can look at a cash flow statement and come up with a meaningful number. Cash flow is an important number in fundamental analysis, but it comes after the earnings. [Also included in 1(b)] **[TI 10/16, p. 8]**

Participant I-8
The emphasis on cash flows has to be there. If you're looking at a company which is going to be a growth company, you're looking to see whether there is sufficient cash generated to finance that rate of growth or whether the company will have to do something to supplement its cash flows. By and large, in the analytical and portfolio management community, the emphasis is on near-term earnings. So there is a greater forecasting efficiency in that timeframe and a lot less efficiency when you try to look out 2 or 3 years. I always try to operate in the area when there is the least amount of efficiency because that's where the greatest opportunity is. **[TI 10/16, p. 9]**

Committee/Staff/Observer
I haven't heard anybody say that they discount predictions of future dividends to arrive at the intrinsic value. Am I correct in dismissing that approach? **[TI 10/16, p. 9]**

Participant I-2
Some institutions use that strictly. **[TI 10/16, p. 9]**

Participant I-12
I think people combine methodologies; discounted dividend model, discounted earnings model, discounted cash flows, and see what the different valuations might be. **[TI 10/16, p. 9]**

Participant I-3
Different methodologies are applicable to different types of industry. I cover a very cyclical industry; I couldn't tell you what dividends will be next year, let alone in 20 years. You have to have a reasonable period of time if you use a dividend discount model. Some industries, it used to be true of electric utilities, were fairly predictable and may be the dividend discount approach was applicable there. **[TI 10/16, p. 9]**

We have to draw a distinction between valuing an entity, what a company is worth, versus valuing its equity. Those of us involved in the investment community are in the business of valuing what an equity is worth. It may be substantially different, including well overvalued, from what the entity is worth. **[TI 10/16, p. 9-10]**

I don't focus a lot on what the low side of valuation might be because, in the highly cyclical industry that I cover, the market will determine that. I am not interested to know, as share

prices of specific companies are falling, where the exact bottom will be; the market will figure that. What I am interested in figuring out is where the bottoming point and turning point upward will be, based upon macro economic indicators and industry fundamentals and then try to identify companies that are postured well enough and whose equities are substantially undervalued. I often look 12 to 18 months but the investment threshold of investors is getting shorter and shorter. **[TI 10/16, p. 10]**

Committee/Staff/Observer
We are touching on question 3. Two of us met individually with a total of about 20 sell-side analysts for about 45 minutes. After those meetings, we compared notes, and we noticed that all the analysts were predicting for 6 to 18 months. Yet, all of the analysts described their approach as the fundamental approach. We didn't hear anything about a 5 year horizon. The meeting materials identify 4 possible reasons for the extreme focus on short-term earnings. Our question is: do analysts focus that much only on short term earnings and, if so, why? **[TI 10/16, p. 10]**

Participant I-9
About half our business is wealthy individuals and the other half is corporate pension plans. For wealthy individuals, our job is to identify the very good growth stock for 3, 5, 10 years: the [names deleted]. We don't want to sell those stocks because if you end up paying 35% tax, and you have a company that grows at 20%, you only have a 13% return. You're far better having a company you can compound out for your clients, and it's self-serving for our business because we get a fee on those deferred taxes that aren't paid. So we will estimate for 1 year of earnings. Then we stop at 3 to 4 years out in terms of making projections because I don't have any confidence beyond that range. This is partly due to my background. At one point, I was a utility analyst; two-thirds of my current year's numbers came within a penny of my estimates. My 3 to 4 years numbers were so bad because interest rate changed (and the economy, and the president) and you started with more information in utilities going into the interview with an industrial company than you come out of. We don't use the discounted cash flow method because it is projecting out one number and then discounting by another number. **[TI 10/16, p. 10-11]**

Participant I-10
In many of the papers that come into our office every day, you will find a column showing secular growth rates, trend line growth rates. This is not earnings next year, 18 months, 2 years, but an attempt to deal with what that analyst believes is a sustainable secular trend. It is normally based on the rate to which capital is being reinvested in business. There is an attempt in that to deal with the longer term dynamics of a particular business. The shorter the time period, the less important it is to have that information. In other words, if you look at a three month period with perfect forecasting, you will not have much of an edge in the market. So the question is why are people spending 95% of their time trying to predict next quarter's earnings when, even if I gave it to you perfectly and you have a large portfolio to manage, it would be of no benefit to you. [Also included in 11(e)] **[TI 10/16, p. 11]**

Participant I-6
Why so much emphasis on short-term earnings? Because my clients want short-term earnings, clearly less than 1 year. [Also included in 11(e)] **[TI 10/16, p. 11]**

Participant I-12
There is a business imperative on the sell-side called trading volume. On the other hand, it serves a worthwhile purpose as an early warning system. There is a wide array of investors out there; those with one year horizon, those with 20 year horizons. The [name deleted] on one hand and the short-term black box traders on the other. The early warning system on earnings 90% of the time doesn't mean anything, but when there is an earnings shortfall or a coming shortfall, that's where Wall Street gets its competitive advantage. So there are a lot of reasons for the short-term system but the balance may have swayed too far in that direction. [Also included in 11(e)] **[TI 10/16, p. 11]**

Participant I-4
We do small capitalization-type investing. Our clients are very cognizant of quarterly earnings and volatility on quarterly basis. We have never lost a client because of quarterly numbers. Even though they may talk about short-term earnings, I don't believe they really focus on them to the extent we hear about all the time. The only way we lose accounts is to do something that you say you won't do, to change or lose your discipline. We have 15-25% turnover a year in our portfolios and that makes us very long term in the sense of how people view us. Our clients don't necessarily penalize us if we have a bad quarter. [Also included in 11(e)] **[TI 10/16, p. 12]**

Participant I-11
In our firm, we make detail models 4 to 8 quarters out and we have a 3 to 5 year trendline growth expectation related to expected ROE. Beyond 3 to 5 years, there are so many exogenous factors that affect the economy and business that you're kidding yourself if you think you know what is going to happen further out. [Also included in 1(c)] **[TI 10/16, p. 13]**

Committee/Staff/Observer
One last question in the area of investors' objectives. As background, several accounting standard-setting bodies around the world have addressed that question and canonized their conclusions in their conceptual frameworks. To our knowledge, each of those frameworks state that from an investor's perspective, the purpose of financial reporting is to help investors predict the amount and timing and assess the uncertainty of a company's future cash flows. Do you agree or disagree? **[TI 10/16, p. 14]**

Participant I-11
Conceptually, that is clearly true. Functionally, that is a meaningless statement. Earnings could be and should be a handy proxy for the increasing net worth of a business. That has to be tempered by the quality of earnings, by cash flow considerations, and so on. Most of us look a lot harder at earnings than we do at cash flow. **[TI 10/16, p. 14]**

Participant I-6
I use cash flow but I don't find it as convenient to arrive at than others do. I find that the statement that accounting bodies around the world try to issue standards that make easier to get cash flows is in contradiction with reality. Look at FAS 106 where another noncash item is being buried in the income statement and the cash flow statement. So accounting bodies

themselves are adding disclosures and accounting practices that are in conflict with the concepts. **[TI 10/16, p. 14]**

Participant I-9
I don't think cash flow is that relevant to us; we look at earnings and earnings growth rate. For start-up companies, cash flow is important because you want to see if they have enough money to do their thing. At the other end of the bell curve, you have problem companies; cash flow is terribly important there. I think it would be helpful to have a cash flow statement over a 5 year period to see if the company is putting all its cash flows in inventories when the sales are going no place, and it is telling to determine whether a company is going to get in trouble. **[TI 10/16, p. 14]**

Participant I-2
I think cash flow is absolutely key. The income statement gives you a number you can talk to your clients about but the health of the business is cash flow. In the case of one company I have followed over a number of years, they have bank lines which mature every 5 or 6 years. Invariably, they mature during a very poor economic environment and they have to raise equity at the absolute bottom of the market. Cash flow tells you when and how much cash these companies will have to raise. **[TI 10/16, p. 15]**

Another thing that cash flow tells you is when a company looks healthy on the bottom line but there is no cash flow behind it. I think cash flow is absolutely the lifeblood of the company. For different industries it is going to vary; for my industry (steel) it is absolutely key. For others, it might not be a factor. **[TI 10/16, p. 15]**

Participant I-1
In our firm, we are involved with both the public markets and the private markets and so that gives us a strong cash flow emphasis. When you're looking at cash flow versus earnings, it's a chicken or an egg. It's a question of whether you're going to add something back or deduct it out. The problem with earnings is that you can make them appear what you want them to be. **[TI 10/16, p. 15]**

There is an issue as to the definition of cash flow. You don't necessarily need a regulatory definition of cash flow as long as two people sitting across a table define the term for themselves. **[TI 10/16, p. 15]**

It's important to see where a company is reinvesting cash flow. Cash flow is most important, particularly when you analyze private market companies. **[TI 10/16, p. 15]**

Participant I-12
What most of us do is trying to figure out what is the value of a business and this is a function of the balance sheet assets plus changes in those assets as a result of business activities. Cash flow is probably the more critical determinant of the change in the value of the assets, but I think earnings is an equally valid measure of the change in assets. **[TI 10/16, p. 15]**

The purpose of external reporting is to give some basis to look at the value of a company today and a basis to look in the change and potential change in that value. [Also included in 1(b)] **[TI 10/16, p. 16]**

Participant I-5
In theory, earnings is almost supposed to be what cash flow is for a company. Earnings was designed, and depreciation and noncash charges were put in there, to tell you what the sustainable level of money coming out of this business would be if you didn't reinvest anything incrementally. When you're looking at an income statement leading into a cash flow statement, what you're trying to do is take out the pieces that aren't real in terms of cost or benefits. For example, amortization of goodwill is not a recurring cost in any economic sense. The distinction between the two is trying to get to the right level of what should be called earnings. But because of our accounting rules, earnings are not always really earnings and that's why today we get into discussing agressively what is cash flow. **[TI 10/16, p. 16]**

Participant I-8
There are just as much adjustments to cash flow numbers or analysis of cash flow numbers as there are if you're looking at earnings. I believe cash flow is more important. When I do a cash flow analysis, I have my own form of abbreviated cash flow statement and I take out nonrecurring items or things that I can't possibly predict. Then I get to a number that is deducted from or added to working capital. Once you get into working capital, there is no way I can predict how management is going to change working capital. Therefore, I would like to see more discussion about, for example, the level of inventory relative to sales and, if they built inventory, why? [Also included in 13] **[TI 10/16, p. 16]**

Participant I-2
Net income is necessary but not sufficient. The cash flow tells the story of how a company is changing. A company who has a very agressive capital spending program and not the balance sheet to substantiate it is going to get into real problem. In basic industries, cash flow is imperative. **[TI 10/16, p. 16]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When asked about the types of information investors use to achieve their objectives, participant I-1 provided more information about his objectives and approach to evaluating equity securities.

Participant I-1
Our approach is starting with the basic 12-page due diligence list, recognizing that you only get half a page of that out of conventional external reporting. The rest of it is digging the information around. A good part of what is on your list has to be obtained from non-external reporting sources; for example, talking to customers and suppliers. You may not get some information from the company you're talking to, so you have to go around it. In other cases, you may have tremendous concentration in the customer base and that may not be evident from the external reporting (although the footnotes may give some concentration disclosures but not as much as we would like). Probably 80% of the information you need has to be obtained either away from the company or have the company sit down and have a candid conversation

with you.. There is disparity in what a company will tell people. We tend to focus on midcap-type of companies which generally enjoy the opportunity to sit down and talk a lot, compared to the Fortune 1000 where it's more institutionalized. Even within those companies, they migth tell person A something different than what they tell person B. So there is a tremendous amount of variability in the other types of information that is disseminated. [Also included in 1(b)] **[TI 10/16, p. 17-18]**

[Context] Responses to the postmeeting questionnaire to the October 16, 1992 Investor Discussion Group meeting.

QUESTION 3

a. **Please rank in importance the following explanations of why analysts focus on predicting short-term earnings.** Please indicate your responses by numbering the following explanations. The number 1 indicates the highest priority, larger numbers indicate progressively lower priority. Use a number only once. **Please do not number any explanation that you believe does not apply.**

They believe that the market price of equity securities over the next 6 to 24 months will be a function of earnings reported for that period. Thus, predictions of near-term earnings enables predictions of market prices of a company's stock in the near term.

Ranking	Number of Responses
1	*6*
2	*2*
5	*1*
Average Ranking	*1.67*

Predicting near-term earnings provides an organized way for the analyst to understand the company's business and the environment in which it operates.

Ranking	Number of Responses
3	*1*
5	*3*
6	*2*
7	*1*
Not applicable	*2*
Average Ranking	*6.11*

They believe that earnings in the short term is often a good predictor of long-term earnings.

Ranking	Number of Responses
2	*1*
4	*3*
8	*2*
Not applicable	*3*
Average Ranking	*6.33*

1(a). Investors' and Creditors' Objectives and Approaches–Page 24

Predicting near-term earnings and understanding the reasons why the company's actual performance differed from predicted performance provides early detection of changes affecting the company relative to expectations.	
Ranking	Number of Responses
2	*3*
3	*3*
4	*1*
5	*1*
7	*1*
Average Ranking	***3.44***

Predictions of longer-term earnings are not sufficiently reliable to be helpful.	
Ranking	Number of Responses
4	*2*
5	*1*
6	*2*
7	*1*
Not applicable	*3*
Average Ranking	***6.56***

1(a). Investors' and Creditors' Objectives and Approaches--Page 25

Portfolio managers and other customers demand predictions of near-term earnings.	
Ranking	Number of Responses
1	*2*
2	*1*
3	*2*
4	*2*
6	*1*
7	*1*
Average Ranking	***3.44***

A track record of accurate predictions of short-term earnings demonstrates the analyst's competence and industry knowledge and builds credibility for the analyst's recommendations.	
Ranking	Number of Responses
3	*1*
5	*2*
6	*2*
8	*1*
Not applicable	*3*
Average Ranking	***6.67***

Sell-side analysts focus on predicting near-term earnings in part to give the sales force material that helps them sell securities to their customers.	
Ranking	Number of Responses
1	*1*
2	*1*
3	*1*
5	*1*
7	*3*
Not applicable	*2*
Average Ranking	***5.56***

Summary of Rankings	
Average Ranking	
1.67	They believe that the market price of equity securities over the next 6 to 24 months will be a function of earnings reported for that period. Thus, predictions of near-term earnings enables predictions of market prices of a company's stock in the near term.
3.44	Portfolio managers and other customers demand predictions of near-term earnings.
3.44	Predicting near-term earnings and understanding the reasons why the company's actual performance differed from predicted performance provides early detection of changes affecting the company relative to expectations.
5.56	Sell-side analysts focus on predicting near-term earnings in part to give the sales force material that helps them sell securities to their customers.
6.11	Predicting near-term earnings provides an organized way for the analyst to understand the company's business and the environment in which it operates.
6.33	They believe that earnings in the short term is often a good predictor of long-term earnings.
6.56	Predictions of longer-term earnings are not sufficiently reliable to be helpful.
6.67	A track record of accurate predictions of short-term earnings demonstrates the analyst's competence and industry knowledge and builds credibility for the analyst's recommendations.

Other explanation	
Participant I-17	Put simply, people (analysts in this case) do what they think is important to do based on what the market thinks is important. Increasingly, the market has indicated that near term earnings are important (one of the best indicators of performance has been whether consensus estimates are rising or falling). So the analyst must respond to this--especially by avoiding earnings "disappointments."
Participant I-9	Short-term earnings reports that deviate from consensus can cause sharp stock price fluctuations in either direction. A deviation in quarterly results from expectations causes an analyst to re-examine and often revise intermediate growth forecasts. Deviation are sometimes a reflection of management's honesty and/or changing competitive situation.
Participant I-11	I did not rank "analyst's competence" because I believe only the obverse is true. A consistently bad track record damages credibility. I did not rank "sales Material" because I believe it is just another way of expressing "customer demand." While I rank-ordered the other items, I believe all are nearly equally important.

b. Please rank in importance the following explanations of why analysts focus on predicting earnings rather than cash flows. Please indicate your responses by numbering the following explanations. The number 1 indicates the highest priority, larger numbers indicate progressively lower priority. Use a number only once. **Please do not number any explanation that you believe does not apply.**

They believe that the future market price of equity securities will be more correlated with reported earnings than with reported cash flows. Thus, predictions of earnings better enables predictions of market prices of a company's stock than do predictions of cash flows.	
Ranking	Number of Responses
1	*5*
2	*1*
4	*1*
6	*1*
Not applicable	*1*
Average Ranking	*2.89*

Earnings is often a good predictor of longer-term cash flows.	
Ranking	Number of Responses
2	*1*
3	*2*
5	*1*
6	*2*
7	*1*
Not applicable	*2*
Average Ranking	*5.56*

Analysts can predict earnings with greater accuracy than cash flows.	
Ranking	Number of Responses
4	*2*
5	*1*
Not applicable	*6*
Average Ranking	*7.44*

Predicting earnings is the first step in predicting cash flows.	
Ranking	Number of Responses
2	*6*
4	*1*
Not applicable	*2*
Average Ranking	*3.78*

Whether an analyst predicts earnings or cash flows depends on the industry and the circumstances facing the company. Analysts will predict earnings when earnings are a good predictor of long-term cash flows. On the other hand, analysts will predict future cash flows in those circumstances when earnings are not good predictors of cash flows.	
Ranking	Number of Responses
1	*1*
2	*1*
3	*3*
4	*2*
5	*2*
Average Ranking	*3.33*

Portfolio managers and other customers demand predictions of earnings and not cash flows.	
Ranking	Number of Responses
1	*2*
3	*5*
5	*1*
Not applicable	*1*
Average Ranking	*3.44*

Other	
1	*Participant I-12:* Earnings as reported are the only common denominator that everyone can independently verify. It is also the number that appears on the broad tape for everyone to see. After the fact, analysts refer to "core" earnings by explaining their own individual adjustments to reported earnings (and everyone makes different adjustments!)

Summary of Rankings	
Average Ranking	
2.89	They believe that the future market price of equity securities will be more correlated with reported earnings than with reported cash flows. Thus, predictions of earnings better enables predictions of market prices of a company's stock than do predictions of cash flows.
3.33	Whether an analyst predicts earnings or cash flows depends on the industry and the circumstances facing the company. Analysts will predict earnings when earnings are a good predictor of long-term cash flows. On the other hand, analysts will predict future cash flows in those circumstances when earnings are not good predictors of cash flows.
3.44	Portfolio managers and other customers demand predictions of earnings and not cash flows.
3.78	Predicting earnings is the first step in predicting cash flows.
5.56	Earnings is often a good predictor of longer-term cash flows.
7.44	Analysts can predict earnings with greater accuracy than cash flows.

[PMQI 10/16, p. 8-13]

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of conservatism. During the discussion, an investor made a comment on his objectives.

Participant I-16
Our job is to put a value on an enterprise, not to make sure that a company won't go out of business; that's not what investors are trying to do. Conservatism is putting a floor estimate on the company's earnings, cash flows, and value. It's highly unlikely that the true value is below that number. For most purposes, that would not be a useful number because most people using financial statements are not trying to come up with a floor number. Most of us are trying to get to a realistic estimate of value and efficient capital markets require that. [Also included in 2(b)] **[TI 3/17, p. 31]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the objectives and approaches used by creditors.

Committee/Staff/Observer
The first question has to do with the objectives of creditors as they look at financial information. The basic objective of creditors can be articulated as follows: *to assess the ability of a borrower to meet the obligations related to a specific debt instrument through timely payment of principal and interest or, as a last resort, through transfer of a collateralized asset.* Do you agree with that characterization, and if you don't, how would you modify it to better describe what a creditor does? **[TC 12/8, p. 1]**

Participant C-1
I would say it's not a specific debt instrument, but debt instruments. And I would add also that it's not just the timely payment of principal and interest, but also the ability of the company to meet financial covenants which senior lending institutions are setting. **[TC 12/8, p. 1]**

Participant C-2
Knowing how difficult sometimes it is to develop definitions that work in all kinds of situations, I thought it was a pretty good definition. Again, there are some other things we do that in a way could be encompassed here. Structure was one comment that you might say is indirectly encompassed in these words; also trying to assess future borrowing needs so that you know whether or not you want to enter into a relationship and make the one specific loan. Finally, I think assessing long term viability is a going concern. You might say all of that is encompassed in these words because in assessing the ability to meet a specific instrument, maybe you are looking at all of those concepts. **[TC 12/8, p. 1-2]**

Participant C-3
I just thought that the concept of debt instrument maybe needed to be broadened to financial instrument to include any potential off balance sheet implications. **[TC 12/8, p. 2]**

Participant C-4
I was also of the opinion that the definition limits it to a fixed income instrument, and I think we should say something about assessing the ability to continue as a going concern. In my line of business, we are more interested in not only the debt instrument, but the ability of the company to handle increases or decreases in revenue or backlog. **[TC 12/8, p. 2]**

Participant C-5
I think the concept of customer viability is really the one that you need to get into the definition. Timely payment is also somewhat narrow; it's timely or viable alternative to timely payment. **[TC 12/8, p. 2]**

Participant C-6

In dealing with privately-held companies, understanding management's and owner's objectives as far as how it relates to the financial statements is also an objective. In those companies, there are adjustments and expenses in financial statements that need to be fully understood by the credit granter to get a better handle on what the numbers actually mean. **[TC 12/8, p. 2]**

Participant C-7
On the objectives, we felt the focus was too narrow just dealing with a specific debt instrument. As a bank we may be secure on a specific loan, but trade credit could push a customer into bankruptcy, substantially increasing our administration costs and diminishing our profitability. So I think the notion of viability for all groups is an issue. **[TC 12/8, p. 2-3]**

Participant C-8
We also felt that the definition, focusing on debt instrument, was too narrow. In the surety bond business, we assess the company's ability to perform the underlying obligation that we have bonded. But part of that review is also to make sure the company can service all of its debt, and that should be included in the definition. **[TC 12/8, p. 3]**

Participant C-9
As an analyst I'm involved in trying to assess the ongoing concern and financial strength of the company in relation to the secondary trading of its debt. So I'm not looking only at the payment, but at the perception of the credit at a given point in time to determine the buyers and sellers, and what price a credit may trade at that point in time. So, I see it as an opening continuum. **[TC 12/8, p. 3]**

Committee/Staff/Observer
Can you contrast with what [participant C-6] was talking about, that is, where you're making the initial decision on whether you're going to work with these folks or not. I would assume that for [participant C-6], it's also an ongoing concern, too? **[TC 12/8, p. 3]**

Participant C-6
Yes. **[TC 12/8, p. 3]**

Participant C-9
Well, I don't know what [participant C-6]'s involved in. It sounds as if he's more a long-term investor or creditor, whereas on a trading situation I may be a short-term holder. **[TC 12/8, p. 3]**

Committee/Staff/Observer
Does that mean that there might be a buy-sell side difference in view here? If you'll let me temporarily narrow the view to debt instruments solely for purposes of that question, is there a buy side view versus a sell side view that gives you different interests? **[TC 12/8, p. 3-4]**

Participant C-10
There are different types of buy side people; for example, short-term trading oriented buy side houses, and there are long-term holders. So I think she was describing more of the short-term trading view, but I'm not sure you can say that there are differences between the buy and the sell side. **[TC 12/8, p. 4]**

Participant C-9
I'm still interested in the long-term health of the company and the investment prospects. **[TC 12/8, p. 4]**

Participant C-1
But I think one of the things this definition leaves out which is very important to us is not a collateralized asset, but the asset value of the company as an ongoing concern. The times that we purchase securities or lend money where we're secured you could count on a hand. We're looking at overall corporate valuation as either an ongoing concern, or else as a breakup. The concept of trading is critical to us in terms of the ability as a mutual fund to mark our securities to market, or even in the private accounts to mark those securities to market on either a daily or a monthly basis. **[TC 12/8, p. 4]**

Participant C-5
We rely very little on the financial statement as a basis for evaluating collateralized assets. We clearly use alternative sources. We're not satisfied with the ability to make those determinations based on the financial statements. We look at business valuation and customer viability based on financial statements, but banks have traditionally developed other systems for collateral valuation. So, if assessing payment through collateral is part of the definition of what our objective is, it is one of ours, but is it an objective that is satisfied or could be satisfied by the financial statements, that's more of a question. [Also included in 1(b)] **[TC 12/8, p. 4]**

Participant C-10
During 1990 when things were so bad in the high yield market, everybody was valuing their debt instruments based on the company value; before that, valuations were based on one time or two times coverage of interest. The point is that we went quickly in one type of valuation through about two different successive steps, and then to a fourth level of valuation in that period when the market was collapsing on us. Now, we're back to more of the normal valuation methods at this point. So my point is we look at all the financial instruments, but we sometimes change the way we look at them at different periods of time. **[TC 12/8, p. 5]**

Committee/Staff/Observer
If in a crunch time you were looking at market values, why would you then go away from that? Why would you then go back to other measures? **[TC 12/8, p. 5]**

Participant C-10
I don't have a good answer for you, but I think it's because the market in effect has gone back there. The market is buying and selling based on the cash flow coverage rate. **[TC 12/8, p. 5]**

Participant C-1
We haven't forgotten what happened in the late 1980s, but we've matured as a market and are back up to being a little bit more realistic in terms of cash flow coverage than we were in the 1980s, and are now looking at companies with two times coverage, or 1.5 times coverage after capex, etc. So it's not that we forgot it, it's just that the shift was made, we've gotten rid of a lot of the companies that we valued on a mass basis, and we're now looking again at coverage numbers. **[TC 12/8, p. 5]**

Participant C-5
The dilemma that's being expressed is that price and value are the same at any point in time, but price and value are different. I don't believe the markets have actually woken up to that. There is continually this dilemma of trying to chase price and claiming that's value. I think the accounting profession has to be careful because they're following, and they're getting into this same chase. [Also included in 4] **[TC 12/8, p. 5-6]**

Committee/Staff/Observer
Can you identify some of the accounting that you think is chasing that incorrectly? [Also included in 4] **[TC 12/8, p. 6]**

Participant C-5
Well, mark to market obviously. [Also included in 4] **[TC 12/8, p. 6]**

Committee/Staff/Observer
[Participant C-5], are the implications of that the same whether it's a debt instrument or whether it's an equity instrument? [Also included in 4] **[TC 12/8, p. 6]**

Participant C-5
Yes. We see this particularly in real estate, more so right now than even in commercial credit. I think some sanity has returned to the commercial markets, but right now we are claiming that real estate value is in fact real estate price, and we are particularly troubled because we can see a tremendous disequilibrium. Risk of decline has been removed from that market, the discounts required in that market are still substantial. We basically are selling properties at 12 times cash on cash, or 12% cap rates, or eight times cash on cash yields with a relatively locked in income stream. We can see the disequilibrium, and we just don't know when the balance will come back, but that's the whole game of investing debt or equity. [Also included in 4] **[TC 12/8, p. 6]**

Committee/Staff/Observer
I would have thought the significance of that might vary whether you're talking about real estate, whether you're talking about an equity instrument, or whether you're talking about a debt instrument, depending on where it sits in a liquidation priority. [Also included in 4] **[TC 12/8, p. 6]**

Participant C-5
Well, that's true. As you come closer to the question of customer viability, then liquidation and price risk becomes particularly relevant. But as you move away from that, it becomes less relevant. The lower you get on the debt structure, the more you look like equity, and so the closer you are, the more it becomes important. [Also included in 4] **[TC 12/8, p. 7]**

Participant C-6
I think the real estate example you were giving is of a specific property. So that's really a security, a very specific thing, whereas I think most of the earlier discussion we were having related to companies. **[TC 12/8, p. 7]**

Participant C-5
Companies are the same thing. **[TC 12/8, p. 7]**

Participant C-6
Yes, but companies are broader and that's where the accounting gets more involved. Whereas in a real estate specific loan, you're dealing with that specific property, and the cash flow out of that property, not so much of an accounting issue. **[TC 12/8, p. 7]**

Committee/Staff/Observer
Question two. There is a set of propositions on what accountants believe to be the purpose of external reporting that are on bullets on page 8 of the meeting materials. The statement above those bullets talks about external reporting principally being there to help investors and creditors predict the amount, timing, and assess the uncertainty of companies' future cash flows, and that statement ties in some propositions. They include:

- First, that credit decisions are rational, and that the creditors expect to receive a return usually in cash.
- Second, that the prospects depend significantly on a company's own ability to bring in more cash than it spends on resources.
- Then, in assessing the amount of time and uncertainty you have to look at prospective cash flows. **[TC 12/8, p. 7-8]**

I'll skip the fourth bullet, I think it's fairly obvious that you need to know about assets, liabilities, revenues, and expenses, and go to the fifth, which I would call your attention to carefully. **[TC 12/8, p. 8]**

Since the first argument was that the amounts, timing, and uncertainty of cash flows is what this may be all about, the proposition is whether or not earnings measured on an accrual accounting basis are actually a better indicator of those future cash flows than cash flows themselves on an historical basis. The proposition being that historical cash flows tell us what has happened, but don't give us major indications of what will happen on the basis of how the

money has already been spent, and that maybe accrual accounting does that better. So, with those things in mind, we'd like your comments on whether or not those propositions, particularly the last one, are ones that you think are what accounting is all about if in fact accounting for your purposes is to look at the amount, timing, and uncertainty of future cash flows. **[TC 12/8, p. 8]**

Participant C-4
I would think the analysts for [companies that have recently failed] would probably disagree with it. I think while the operating cash flow in any one year may show some volatility, operating cash flow analyzed over time or free cash flow analyzed over time is a much better assessment of the company's ability to meet future cash obligations than accrual accounting. **[TC 12/8, p. 8]**

Participant C-11
I am very disturbed by the last bullet point. I don't personally think that there is one way to do your analysis, that cash flow, per se, is the only way to go, or that accrual accounting is the only way to go. The way that you analyze a company is going to vary depending on the business that you're dealing with, and all kinds of different things. Often, you will be using both kinds of approaches, or want to have an accrual, or want to look at good, pure cash flow. So I think that bullet point, number five, really gets us way off the track. [Also included in 1(c)] **[TC 12/8, p. 9]**

I'd also say, with regard to all of the bullets in thinking about this, that there is something missing, which is more balance sheet related items. I happen to be more emphasizing in my own work on analysis of financial intermediaries, and an extremely important thing that you analyze is the trend of various loans or investments or deposits, or whatever the items may be. This seems to be missing from all of the elements here. Your trend analysis of various balance sheet items is just as important as the trend analysis of revenues or costs. The emphasis on balance sheet items also gets me into a discussion of mark to market in the sense that if you mark to market your financial statements, number one, you lose all those trends, but also you are departing from cash in the sense that your loans and investments after all do end up getting paid at a stated amount at some maturity date. And so for several reasons I think that the accrual and cash accounting tables and analysis are both important, and then secondly I think the balance sheet has to be brought into a lot more focus on these bullets. [Also included in 1(c) and 4] **[TC 12/8, p. 9]**

Participant C-12
I had a comment more on the other side of the balance sheet, focusing on the second and third bullets. Looking at cash flow is nice; I look mainly at financial institutions, as well. I think what's important is to know what is the ability to maintain the capital structure? I think that comes back to the idea of long-term viability of a company. Also what happens if they don't? What's the next increment down if some source of funding disappears? **[TC 12/8, p. 9]**

Participant C-2
I also found this very disturbing, and it sounded to me as if it were not written by a user of financial statements for the purpose of credit granting. Because it does seem to me that you really have to understand both the accrual cycle and the cash flow cycle, and how they move

in relationship to each other over time. And you cannot exclude one or favor one over another and make any kind of informed judgment. So I thought it was very disturbing, and I do think that past trends can be a very good indicator of what will happen in the future. **[TC 12/8, p. 10]**

Participant C-14
I think I'm in agreement with everybody on what's being said here. [Participant C-12] has an excellent point, which I would have made also, which is that bullet two assumes the entity earns more cash than it spends on resources. But today what's truly realistic is that companies refinance a lot of their obligations. So I would have reworded bullet point three to say external reporting provides information assessing companies prospective cash flows from operations as well as its ability to continue to access the capital markets. My thinking is not far enough advanced yet in terms of how accounting information can help with that, but it may be through the footnotes where really we're finding all the valuable information these days. **[TC 12/8, p. 10]**

I also want to say I'm in agreement with [participant C-11] also in that while we focus on cash in our analysis, we'll look at accrual accounting to see if the company is able to recover its costs and its pricing. And that's important, but when you start to make projections, that isn't always helpful in your projections. In your projections you start looking at, rather than depreciation on the assets that are currently on the balance sheet, you're looking at what the company is spending on new assets, and that's a better gauge by which to look at future cash flows. Accrual accounting to me seems to be a much more balance sheet kind of approach, and I'm not sure that that really ties in with projecting future cash flows very well. [Also included in 1(c)] **[TC 12/8, p. 10]**

Participant C-9
In looking at external reporting for financial institutions, one of the things that I've needed to look at over the last several years is obviously the asset quality. And clearly the issues that we look at change over time. A decade ago liquidity was the most important thing. But asset quality is what we've been looking at now, and I think we're probably moving into an era where liquidity will become the foremost issue. **[TC 12/8, p. 11]**

But on asset quality what I need to know from external reporting is balance sheet information on what the composition of loans is, what the quality is, and interestingly, if the quality is not good, then we're looking at a non-cash charge to reserves. So, a lot of what I'm looking at is not even cash, but it's an assessment of the ongoing concern elements, the judgment of management and the businesses that they are operating, the judgment of the credit underwriters. **[TC 12/8, p. 11]**

Participant C-6
Just to pick up a little bit on what [participant C-9] said, but from a different point of view, looking at, again, privately-held companies, which is what we deal with. We look at granting credit in a very traditional way, looking at historical information. We don't place a lot of faith on projections, and we look at a very traditional aspect of cash flow: profitability. As far as asset value, we place a fair amount of emphasis on asset value, meaning the primary assets of the companies that we deal with (accounts receivable and inventory) and knowing what those

assets comprise of, and what the quality of those assets are, which is of utmost importance to us. [Also included in 1(b) and 4] **[TC 12/8, p. 11-12]**

Participant C-1
One of the problems that we run into between accrual accounting and cash accounting is that accrual accounting now has become so complex, with all the new accounting standards that have been coming out, that it's becoming very difficult for us to go from accrual accounting back to cash accounting. And most of the companies that we see, and most of the bankruptcies that we've worked on, have had very nice income statements, very nice balance sheets, but the problem is that they run out of liquidity. We look more and more at the income statement, the cash flow statement, and the current accounts or the current part of the balance sheet in order to determine liquidity. [Also included in 2(d)] **[TC 12/8, p. 12]**

The other problem we have is that each of the different forms of public information you have all have different information. It's very difficult to go from a proxy statement or from a 10K to a 10Q, and to go back. So the seasonality of cash flow--and that's what really we've found has tripped up most companies is the seasonality of cash flow--is important, but also sometimes very difficult to go back and forth between. [Also included in 1(b) and 2(d)] **[TC 12/8, p. 12]**

Participant C-13
If you want to think about the difference between cash and accrual accounting, the classic example is a life insurance company where the better the premium income is, the less the cash flow is. No investor in a life insurance company doesn't look very carefully at the statutory statements and compare them with the GAAP statements. It's just the classic example of the need for both statements that [participant C-11] talked about. **[TC 12/8, p. 12]**

Participant C-2
I have one point, and perhaps I was reading the second bullet too narrowly, but we also do a fair amount of lending to non-profits and to government entities, and I think in some cases it's very acceptable to try to just have as much cash come in as you spend in resources, and look to other areas of funding such as endowments, and so forth. It was just a point that there are other types of entities that are worthy of receiving funds. **[TC 12/8, p. 13]**

Committee/Staff/Observer
Questions 3. To what extent , if any, do you consider the entrenched intrinsic value of a company as you think about credit? We have a mirror group of folks that are equity side people who meet like this, and clearly intrinsic value of company is a very big discussion with them, including things like normalized core earnings. So what we're trying to find out is whether or not their concerns and your concerns run parallel, or on different paths, and if so, how. [Also included in 5(a)] **[TC 12/8, p. 13]**

Participant C-1
We use multiples of cash flow. So we're using earnings before taxes, depreciation, amortization, and multiples of that. The problem with determining normalized or core earnings is the amount of so-called one time charges which are always run through a company's income statement. The amount of time spent looking at pro forma cash flows or

pro forma earnings is tremendous. The number of companies selling divisions, selling plants, closing plants, or looking at buying companies and then merging them makes it very difficult for us to look at normalized cash flow and determining intrinsic value of that. [Also included in 1(c) and 5(a)] **[TC 12/8, p. 13]**

Participant C-7
Looking at it from a bank standpoint as a creditor, our focus is on quality of earnings, the composition of operating earnings, and whether that gives you a comfort level going forward that you're going to be repaid. Typically, we collateralize ourselves--we're in a senior position. So, intrinsic value of a company probably is a secondary or tertiary issue for us. **[TC 12/8, p. 13]**

Participant C-5
Actually from the bank group population, as well, I would contrast. We are a bank lender that maybe lends a little bit down the tier of bank credit. Bank debt or any debt is really just a put on equity for the owner of the company, and we have an understanding that that intrinsic value has a lot to do in determining our success, the customer's viability, and then ultimately the repayment of our debt as expected. We do play heavily into intrinsic values, both using price earnings multiples, and then also discounting methodologies. [Also included in 1(c)] **[TC 12/8, p. 14]**

Participant C-11
I maybe have a different approach because of the way we invest or whatever, but I think the way this is phrased is a little bit too skewed to the recent history of LBOs and divestitures and manipulations of that sort. In my mind, I'm hoping that I'm investing in something that has intrinsic value because that value is a going business, producing reasonably reliable amount of cash flow or profits which over time is going to allow me to get paid off. So, I think I'm thinking in a slightly broader framework than this is written in, because I don't think that you should really count all the time on getting bailed out by divestiture or sale at some multiple, because those things don't happen that easily. **[TC 12/8, p. 14]**

Committee/Staff/Observer
So would that drive you, [participant C-11], to quantify the intrinsic value? Or is it just a notional thing that says this company is good? **[TC 12/8, p. 14]**

Participant C-11
In my own work, I'm not thinking of a specific number or value. It's more that it has value because it produces whatever you have to have it produce, cash flow or earnings, or whatever it takes, and the ability to refinance and all those things that were mentioned earlier to allow me to be comfortable with holding the debt and knowing I'm going to get paid off. **[TC 12/8, p. 14]**

Participant C-14
We don't use intrinsic value. The people that are experienced and have seen that values are fleeting, generally find, I think, that intrinsic value for the creditor is not very useful. But a more important issue is the way this question is stated; it almost asks us to make a judgment about whether intrinsic value is something we should or shouldn't be using. And if [one

company] likes to use intrinsic value, and [another] doesn't, I don't think that that really matters. Because when [participant C-5] does his work, or when I do my work, if he's doing intrinsic value and I'm doing cash coverage, we're both still using the same thing: core cash flow. So the real issue is what's the information that we need out of the accounting to answer [participant C-5]'s question, [participant C-11]'s question, or my question about. **[TC 12/8, p. 15]**

Participant C-4
We will use intrinsic value to try and determine whether or not it's prudent to allow goodwill in our analysis. For example, there has been a purchase and we are trying to determine what the value of that company is, we may use a weighted average intrinsic value calculation that used multiple of earnings, multiple of cash flows, and then about 10% or so, or a liquidation multiple. And we found that to be useful. The IRS also bought that calculation. So we felt that it was useful. [Also included in 1(c)] **[TC 12/8, p. 15]**

Participant C-1
Well, one of the interesting things about intrinsic value from a creditor's standpoint is that we operate as part of an overall financial community. We all have to be cognizant of the way the equity markets value companies because for all of us part of the way of improving a company's valuation is obviously to sell stock. I think that while a lot of us may not agree that PE multiples are a great way of looking at intrinsic value, they're very important in determining the company's ability to access the capital markets. And that intrinsic value is important because the equity market cares about it. **[TC 12/8, p. 15]**

Participant C-14
I think it's a really good point, because if there is high intrinsic value, the company can have more financial flexibility. But one of the problems that I think creditors face is what management intentions are. When equity values are high, management may be willing to sell some stock to bolster the balance sheet, but when equity values are low, for instance in [name deleted] case when they should have been selling stock when equity values were low, that they were instead buying stock, because [the Chairman's] view was that this stock was "undervalued." Management makes these judgments that really cloud the issue of how much that intrinsic value is going to help the creditor. **[TC 12/8, p. 15-16]**

Participant C-1
I agree with you, but management's intentions are unfortunately something that are never in financial statements. One of the key things that we look at is trying to determine management's intentions. Management's got the ultimate club, as far as creditor's are concerned, which is Chapter 11. And they use it more and more, and there's nothing we can do to control that. I agree [participant C-14] that the key thing for us is the ability to cover interest. However, if intrinsic value is not there, at any point in time management can exercise their ability to go into Chapter 11. Time after time, management comes out better after Chapter 11 than when they went in. **[TC 12/8, p. 16]**

Participant C-5
I think the whole issue of the equity markets does not change the intrinsic value of the company. What I've heard a few people mentioned is that the concept of value proved to be

very ineffective in the eighties; I think it's because the information provided was not sufficient to make those valuation determinations. We were making some very subjective valuations. Because of the lack of information, we've always assumed price is value. **[TC 12/8, p. 16]**

Participant C-12
I think one of the reasons I'd come back to intrinsic value over time, without trying to put a value on a company, but just to determine that there is some value there, is that companies with value will attract capital. One other general thought; in looking at a financial institution, I look at two things. One is intrinsic value, the ability to generate earnings. The other is the impact of a discontinued operation, which is loan loss provisions. What I'm doing looking at a financial institutions is evaluating the ability to generate value from the core business against the cost of getting out of the business that went wrong. **[TC 12/8, p. 16-17]**

Participant C-3
We've increasingly gone to a concept of stressed capital where we look at the potential charge of a company's exit from a certain industry or geographic area and its impact on capital. [Also included in 1(c)] **[TC 12/8, p. 17]**

Participant C-14
I want to give an example of the problem we have with intrinsic value. [Name deleted] came in to get a rating and we all know [name deleted] had a high flying stock 18 months ago, $80 maybe. Its intrinsic value was tremendous, and if you rated it on intrinsic value you would have been well into an investment grade, maybe an A rating, and that's what the investment banking community was pushing. But if you did the analysis, the cash flow didn't support that kind of rating. And pure fundamental analysis told you that it wasn't good credit. And that's why we get scared about putting too much faith in intrinsic value. **[TC 12/8, p. 17]**

Participant C-5
We've done some significant analysis in terms of moving to a re-rating system within our bank, modifying the past rating approach. What we've seen is a point where you shift your focus, whether it's accrual versus cash. On the high end credit accrual is very important because it really does get down to period reporting. Cash becomes important when liquidity and viability is more of a question. The same thing goes with things like segment reporting versus legal entity. The more concerned I am about viability, the further I move down the curve. If I am more concerned with the pieces of the debt, how I control the debt structure with the whole consolidated group, I then move up the curve. Businesses are not managing legal entities, they really are managing segments. The concept should be that we have a set of tools; obviously, as a bank creditor we can demand preparation of financial statements in certain fashions as long as we have an agreed-upon standard upon which those can be prepared. For a company that we would grade a borderline pass credit, we would not ask for segment reporting, we'd need legal entity consolidations. For a company that's a high grade multinational, typically they would provide more segment-type information. I don't believe standards should be different but the on-off switch should be there to shift the focus in the middle at the point where the debt holders make some determinations as to which are more important. I know that's a difficult thing to implement, but we have clearly seen that there is a shift about middle of the pass grade, which would be basically minimum investment grade

type credit, there's a shift away from cash viability to accrual and legal entity to segment type information. [Also included in 3(b)] **[TC 12/8, p. 22-23]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 1

Do you agree with the following *revised* statement of objectives of financial analysis performed by creditors (including credit rating agencies, banks, and other institutional investors):

To assess the ability of a borrower or issuer of debt securities to meet obligations related to current or future debt or other financial instruments through timely payment of principal and interest or, as a last resort, through transfer of a collateralized asset.

That assessment involves considering some or all of the following pertaining to a borrower or issuer of debt securities:

•The long-term viability of a borrower to be able to operate as a going concern, including being able to access capital markets to meet future borrowing needs,

•The appropriateness of and borrower's ability to meet lending agreement covenants,

•The fair or market values of its assets pledged as collateral on its debt,

•Management's objectives, particularly in relation to a borrower's current and proposed borrowings,

•The fair or market values of its assets pledged as collateral on its debt, and

•In some circumstances, the ability of the company's debt to be traded in secondary markets.

•Other :

Participant C-3 - Fair or market values of assets not pledged as collateral.

Participant C-14 - Ability to liquidate collateral in a timely fashion without undue impairment of its protection of debt service.

Participant C-10 - The projected cash flow of the borrower and how it relates to the interest payments, debt amortization, and capital expenditures.

Do you generally accept this revised statement of objectives?

_ YES **14** _ NO **2**

If NO, what changes would you make?

Participant C-10 - Use the term "cash flow". Don't be afraid to use such a common term. Try #7 and number it #1 - it covers some of point #1 but is much more inclusive.

Participant C-18 - I agree with everything <u>except</u> references to assessing fair value of assets pledged as collateral. Financial statements, GAAP or otherwise, are not reliable sources of information for such purposes; they can significantly overstate or understate value as "value" relates to collateral for a debt obligation.

Participant C-9 - The appropriate risk premium level to "risk free" treasuries in the secondary market to balance the fundamental credit risk with reward.
[PMQC 12/8, p. 1-2]

QUESTION 3

a. If you estimate the "intrinsic value" of the borrower's business, that is, the value of the business as a whole, do you agree with the following (leave blank if you do NOT make this estimation)?

The principal purpose<u>s</u> of estimating the value of a borrower's business include:

	AGREE	**DISAGREE**
i. Assisting in determination of the borrower's ability to weather successfully adverse future economic conditions.	**6**	**2**
ii. Ability of a borrower to attract capital to finance future economic activity.	**9**	**0**
iii. Other reason:	**4**	

Participant C-3 - Ability of the borrower to raise capital through asset sales.

Participant C-14 - Do not use.

Participant C-15 - Do not compute. Cash flow is the basis of an analysis.

Participant C-10 - Assisting in determination of potential sale. Value Co. (chapter 7 for liquidation or more likely going concern values used in a Chapter 11 case)

Participant C-12 - I can be wrong, *i.e.*, in evaluating various aspects of a company's business (both because of my error in judgment and the company's shortcomings in presentation). Uncertainty about specific judgments, *e.g.*, ability to replace a maturity bank loan, is more or less important based on the greater or lesser intrinsic value of the company. (This may simply be a broader way of stating points "i" and "ii", which are examples of uncertainties that will affect future performance.)

Participant C-4 - To determine the ability of the borrower to handle additional equipment debt, increased backlog or revenues or handle changes in the nature of the operation.

Participant C-18 - N/A

Participant C-16 - *Regarding 3ai:* Such ability to weather adversity may include access to capital (ability to borrow). *Other Reason:* Compare book value to market.

Participant C-2 - I generally only make this estimation in loans for the purpose of acquiring an existing business. I compare the contract price with intrinsic value, to ensure that my customer is not overpaying for the business. I will also use asset appraisals to help make that determination, along with DCF methods.

Participant C-19 - *Other Reason:* Plus possibly some amount for the market value of the company's real estate over its book value.
[PMQC 12/8, p. 7-8]

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on creditors' objectives and approaches.

Participant C-7
From a banking standpoint, our focus is on that which we've taken for collateral, generally fairly specific tangible assets as opposed to trying to value the intrinsic value of a business. We really don't get concerned with value until we are in liquidation. [Also included in 4] **[TC 2/2, p. 2]**

Committee/Staff/Observer
Are you saying that ability to recover amounts otherwise uncollectible are where you're coming from? [Also included in 4] **[TC 2/2, p. 2]**

Participant C-7
Yes. [Also included in 4] **[TC 2/2, p. 2]**

Participant C-17
I get real interested in what assets are worth or what the fair market value is the more I rely on security or also as a way to try to evaluate an extra strategy if the company fails. But in the normal course of business, I'm going to be looking to the ability of the company to pay, I don't want to liquidate the company in order to get repaid. I'm looking at that more as a backstop. I look also at market value to make the decision as to whether or not and what type of collateral I need. [Also included in 4] **[TC 2/2, p. 4]**

[Context] The paper is a summary of a committee and staff members' discussions with selected sell-side analysts from Bear Stearns:

"Morning Call" is a meeting (usually via a conference call) between the Bear, Stearns analysts and the sales force where the analysts communicate the results of recent research (and a strong, buy, hold, or sell recommendation) and the expected impact on securities of recent information (e.g., press releases, meetings with analysts, changes in interest rates, economic outlook, and other market factors). [Also included in 1(b)] **[BEAR STEARNS, p. 1]**

Items mentioned during the analyst reports on the morning call were as follows . . . :
- Oil reserve increases resulting from recent drilling activities
- Sales trends, profit margin trends, sales by product line
- Gross margin trends
- Impact on tax rate resulting from nondeductible goodwill
- Foreign currency benefits
- Core business trends and focus markets
- Earnings momentum
- Leading indicators for a particular company and/or industry.

[Also included in 1(b)] **[BEAR STEARNS, p. 1]**

[One analyst] expressed the following . . . regarding his approach to securities analysis: [Also included in 1(b), 2(c), and 15] **[BEAR STEARNS, p. 1]**

- His model is earnings (P&L) oriented and focuses on gross margin trends and the momentum of earnings. **[BEAR STEARNS, p. 2]**

[One analyst] stated that his analysis of a security does not use a discounted cash flow approach, except on certain "asset plays" (i.e., companies that have assets that Wall Street has overlooked--"hidden assets"). **[BEAR STEARNS, p. 2]**

[One analyst commented on the] following regarding her approach to securities analysis and financial reporting in general: [Also included in 1(b), 5(c), 6, and 15] **[BEAR STEARNS, p. 3]**

- Her securities analysis model uses a variation of a "free cash flow" approach. **[BEAR STEARNS, p. 3]**

[Context] Annually, the Corporate Information Committee [CIC] of the Investment Management and Research rates the annual reports of publicly held companies. The checklist presented below contains the questions the CIC analysts consider in performing their evaluations.

CHECKLIST OF CRITERIA FOR EVALUATING FINANCIAL COMMUNICATIONS EFFORT

Qualification Questions (mandatory for each subcommittee's evaluation form)

1. To your knowledge, during the past year has the management of this company suppressed or misrepresented material facts adverse to the company and/or its operations or outlook?
2. In your opinion, are any accounting or other managerial practices of this company materially misleading?
3. In your opinion, is this company unduly dilatory with respect to its press releases and/or earnings statements?

(If you have answered any of these questions in the affirmative, do not proceed with the rating of this company but contact the subcommittee chairman. An affirmative answer to one of the questions by two or more subcommittee members will disqualify the company from being considered in this year's rating.)
Note: The percentage weights appearing after each major category title (below) can be distributed to subcategories in whatever manner seems appropriate to each subcommittee. **[AIMR/CIC92, p. 109]**

I. **Annual Published Information** (40% to 50% of total weight)

A. *Annual Report*

1. **Financial Highlights**--(is it clear and unambiguous?)

2. **President's Letter Review**--(Does it hit the highlights of the year in an objective manner? Is it relevant to the company's results and candid in appraising problems?) It should include:
   a. Review of the year.
   b. Insights into operating rates, unit production levels and selling prices.
   c. Acquisitions and divestments, if any.
   d. Government business, if material.
   e. Capital expenditures program; start-up expenses.
   f. Research and development efforts.
   g. Employment costs, labor relations, union contracts.
   h. Energy cost and availability.
   i. Environmental and OSHA costs.
   j. Backlogs.
   k. New products.

l. Legislative and regulatory developments.
m. Outlook.
n. Unusual income or expense. **[AIMR/CIC92, p. 109]**

3. **Officers and Directors**
   a. Age, background, responsibilities of officers.
   b. Description of company organization.
   c. Outside affiliations of directors.
   d. Principal personnel changes. **[AIMR/CIC92, p. 109]**

4. **Statement of Corporate Goals**
   What are the short- and long-term corporate goals and how and when does management expect to achieve them? (This section could be included in several areas of the report but separate treatment is preferred.) **[AIMR/CIC92, p. 109]**

5. **Discussions of Divisional and/or Segment Operations**
   a. How complete is the breakdown of sales, materials, costs, overhead, and earnings?
   b. Are the segments logical for analytical purposes? Do they parallel lines of business?
   c. Are unusual developments explained with management's response included?
   d. Note comparisons with relevant industry developments to include:
      1. Market size and growth.
      2. Market penetration.
      3. Geographical divergencies.
   e. Foreign operations:
      1. Revenues, including export sales.
      2. Consolidated foreign earnings vs. equity interest.
      3. Market and/or regional trends.
      4. Tax status. **[AIMR/CIC92, p. 109]**

6. **Financial Summary and Footnotes**
   a. Statement of accounting principles, including explanation of changes and their effects.
   b. Adjustments to EPS for dilution.
   c. Affiliates-operating information.
   d. Consolidated finance subsidiaries-disclosure of separate balance sheet information and operating results.
   e. Cash flows statement (FAS 95).
   f. Tax accounting-investment tax credits identified; breakdown of current and deferred for US and non US tax jurisdictions; reconciliation of effective and statutory tax rates; impact of changes in tax law; early application of FAS 96.
   g. Clarity of explanation of currency exchange rate accounting.
      1. Impact on earnings from Balance Sheet translation if any.
      2. Indication of "Operating" or Income Statement Effect of exchange rate fluctuations.
   h. Property accounts and depreciation policies:

1. Methods and asset lives used for tax and for financial reporting.
2. Quantification of effect on reported earnings of use of different method and/or asset lives for tax purposes.

i. Investments: composition and market values disclosed.
j. Inventories: method of valuation and identifying different methods for various product or geographic segments.
k. Leases, rentals: terms and liability.
l. Debt repayment schedules.
m. Pension funds: costs charged to income, interest rate and wage inflation assumptions; amount of any unfunded past service liability; amortization period for unfunded liability (FAS 87).
n. Other postemployment benefits: pay-as-you-go amount, discussion of potential liability and impact of FASB Standard 106, including plans to fund, or amend plans, and Standard 112.
o. Capital expenditure programs and forecasts, including costs for environmental purposes.
p. Acquisitions and divestitures (if material):
   1. Description of activity and operating results.
   2. Type of financial transaction.
   3. Effect on reported sales and earnings.
   4. Quantification of purchase acquisitions or small poolings that do not require restatement of prior years' results. (When restating for pooling, both old and new data are useful for comparison.)
q. Year-end adjustments.
r. Restatement of quarterly reports to year-end accounting basis.
s. Research and development and new products; amount and types of outlays and forecasts.
t. Contingent liabilities, particularly environment.
u. Derivation of number of shares used for calculating primary and fully-diluted earnings per share.
v. Disclosures of the fair values of financial instruments (FAS 107).
w. Goodwill-amount being amortized and number of years.
x. Ten-year statistical summary:

1. Adequacy of income statement and balance sheet detail.
2. Helpfulness of "nonstatement" data (e.g. number of employees, adjusted number of shares, price of stock, capital expenditures, etc.) **[AIMR/CIC92, p. 110]**

B. 10-Ks, 10-Qs and Other Required Published Information **[AIMR/CIC92, p. 110]**

II. Quarterly and Other Published Information Not Required (30% to 40% of total weight)

A. Quarterly Reports

1. Depth of commentary on operating results and developments.
2. Discussion of new products, management changes, problem areas.
3. Degree of detail of profit and loss statement including divisional or segmental breakdown.
4. Inclusion of a balance sheet and cash flow statement.
5. Restatement of all prior and current year quarters for major pooling acquisitions and quantification of effect of purchase acquisitions and/or disposals.
6. Breakout of nonrecurring or exceptional income or expense items including effects from inventory valuation and foreign currency translation factors.
7. Explicit statement of accounting principles underlying the quarterly statements.
8. Timeliness of receiving reports.
9. Separate fourth quarter report. **[AIMR/CIC92, p.110-111]**

B. Other Published Material

1. Availability of proxy statements (even though this is required public information).
2. Annual meeting report: available with questions and answers and identity of those posing questions.
3. Addresses to analysts' groups: available with questions and answers.
4. Statistical supplements and fact books.
5. Company magazines, newsletters, explanatory pamphlets.
6. Press releases: Are they sent to shareholders and analysts? Are they timely? Do they include earnings numbers?
7. How are documents filed with public agencies made available (SEC, Federal Trade Commission, Dept. of Labor, court cases, etc.)? Does the company disseminate all material information in 10-K,10-Q, and similar reports? **[AIMR/CIC92, p. 111]**

III. Other Aspects (20% to 30% of total weight)

A. Is there a designated and advertised individual(s) for shareholder and analyst contacts?
B. Interviews:
   1. Knowledgeability and responsiveness of company contact.
   2. Access to policymakers and operational people.
   3. Candor in discussing negative developments.
C. Presentations to analyst groups: frequency and content.
D. Company-sponsored field trips and meetings.
E. Annual meetings:
   1. Accessibility.
   2. Worthwhile to shareholders and analysts? **[AIMR/CIC92, p. 111]**

[B]uy and sell side analysts of banks and thrifts . . . primary focus [is] understanding the sources of historical earnings and estimating the amount of future operating earnings. Analysts state that their focus [is] on going concern values, such as normalized operating earnings and trends, as opposed to liquidation values. **[KPMG BANK STUDY, p. 38]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

[Some]. . . analysts. . . have a short-term focus. They are preoccupied with predicting a company's financial performance for the next 18-24 months. Using those predictions of financial performance, they then form judgments about the company's future stock price based on multiples and ratios that they believe the market will apply to those predicted amounts. Those multiples and ratios often include (1) price to earnings, (2) price to book equity, (3) price to cash flow or free cash flow, (4) dividend yield, (5) ratio of book earnings to book equity, (6) ratio of book earnings to book assets, (7) debt to equity ratios, and others. Obviously, the analysts' predictions of future stock prices provides the basis for their buy, hold or sell recommendations. [Also included in 1(b) and 1(c)] **[GOLDMAN, p. ii]**

[Some]. . . analysts. . . follow the anticipation approach. As discussed in the Subcommittee's paper "Methods of Portfolio Management and Identifying Stocks for a Portfolio", investors following the anticipation approach believe that stock prices are closely correlated to reported earnings or the rate of growth in reported earnings. Thus, those investors focus on predicting book earnings. However, the short-term focus of the anticipation approach distinguishes it from the fundamental approach, which has a longer-term perspective. [Also included in 1(b) and 1(c)] **[GOLDMAN, p. ii]**

To better predict a company's short-term financial performance, the analysts focus on the industry's and company's detailed operations. For example, they desire to understand the nature of the specific products produced and services rendered, they try to predict the demand in units for those products and services, and they seek to understand the detailed costs for a specific company to provide those products and services. Each analyst stressed the importance of industry experience and a detailed understanding of the company's operations. The analysts

get that understanding from many diverse sources, including frequent contact with management and periodic field trips to companies. [Also included in 1(b) and 1(c)] **[GOLDMAN, p. ii]**

[Another analyst] covers 13 larger banks in depth and is conversant on the financial operations of about 50 in total. Her emphasis is on earnings and earnings growth. She wants to know what is happening in various financial areas such as loan volume, fees, expenses, loss provision, etc. Her customers are large money managers (funds). She spends approximately 40% of her time on analysis, 40% of her time on sales efforts to buy side investors and 20% on other activities. [Also included in 1(b)] **[GOLDMAN, p. 1]**

[A third analyst] covers large drug companies that are global in nature and that have market capitalizations of $8 - $60 billion. He says investors are driven basically by the future growth prospects of drug companies. He wants an analysis of the research pipeline, since that will lead to profitability. He focuses on the income statement and the cash flow statement and says that the balance sheet is much less important. [Also included in 1(b)] **[GOLDMAN, p. 2]**

[One analyst] spends approximately 1/3 of his time on research, 1/3 of his time on selling activities, and 1/3 of his time on investment banking activities. **[GOLDMAN, p. 3]**

[A fourth analyst] spends about 50% of his time looking for new ideas - new companies to recommend. He spends about 30% of his time on actual research after he has identified these companies, and about 20% on marketing and sales efforts. **[GOLDMAN, p. 3]**

[One analyst] believes accounting should strive to avoid volatility in earnings and he stated that the pooling concept makes numbers hard to compare. He believes there should be one standard for accounting and specifically mentioned his unhappiness with the choice of either of LIFO or FIFO. He tends to look at five years back and projects two years forward. [Also included in 1(b), 7(c), and 8(a)] **[GOLDMAN, p. 3]**

[A fifth analyst's] job is to determine for investors which stocks to buy, sell, hold, and the timing thereof. He spends more than 1/2 of his time in investment banking. He uses a wide variety of tools and he uses financial statements with a large grain of salt. He seemed to be quite cynical and repeated over and over that earnings can be manipulated. [Also included in 1(b)] **[GOLDMAN, p. 4]**

[Foreign] financial analysts examine companies and groups (both listed and unlisted) in time (analysis of development) and in space (comparison with competitors). Their analyses are taken into consideration by individuals and institutionals when taking the decision to make financial investments. Furthermore, they are at the core of financial engineering in takeovers or when strengthening share capital, for instance. **[BETRIOU, p. 1]**

[Context] On November 17, 1992, a committee member and staff met with a buy-side equity analyst. The materials for the first meeting of the Investor Discussion Group provided the basis for the discussion.

[In] analyzing equity securities, the fundamental approach [is used]. **[FREEDMAN, p. 1]**

[The buy-side equity analyst] agreed with the following statement about the purpose of external financial reporting and the role of accrual based earnings in serving that objective:

- From an investors perspective, the purpose of external reporting is to help investors predict the amount and timing and assess the uncertainty of the company's future cash flows.

- Earnings often are a better indicator of a company's cash flow prospects than information about its current cash receipts and payments because to a significant extent current cash flows result from past operations and constitute investments in future operations and do not represent consequences of current operations or good predictors of cash flows of future periods.

[FREEDMAN, p. 1]

The following information [was provided] about how investors [using] the fundamental approach determine the intrinsic value of an equity security:

- Most fundamental investors apply a multiple to their estimates of the company's current year earnings. Those investors determine the multiple by reference to (1) the multiple applicable to the fortune 500 or other wide measure of the market, (2) the multiple applicable to the company's sector or industry, and (3) the analysts' judgment about the company's risk and its prospects for growth relative to their expectations for the market, sector or industry. In judging prospects for growth, analysts often predict earnings in detail for the current and the next year, and in less detail for the next three years.

- In some circumstances investors discount at a risk-adjusted rate of return their predictions of the company's future cash flows. Those circumstances include, for example, companies in the start-up phase like biotech and cable companies.

[FREEDMAN, p. 1-2]

[The buy-side equity analyst] agreed with [the] observation that analysts focus on predicting near-term earnings, [believing] that analysts focus on near-term earnings because:

- Predicting near-term earnings and understanding the reasons why the company's actual performance differed from predicted performance provides early detection of changes affecting the company relative to expectations.

- Earnings in the short-term is often a good predictor of long-term earnings.

[FREEDMAN, p. 2]

Two related questions [were asked]: (1) in which of the above categories are [the] primary sources of information something other than external reporting, and (2) for those categories, [should] that information be required in external reporting. Expanding external reporting for any of the categories of nonfinancial business reporting [was not supported] because (1) [there is] doubt whether mandatory reporting would result in better information than [is] current[ly] provide[d], and (2) external reporting would provide the information too late to be useful. [The] focus [is] on what [should be] believe[d] are serious problems in the financial reporting portion of external reporting. **[FREEDMAN, p. 3]**

[U]nderstanding [was confirmed] of how securities firms evaluate sell-side analysts. To summarize, evaluations flow from [three] sources:

(a) the sales force
(b) survey's of customers about why they directed securities transactions to the trading desk of the security firm
(c) ratings of analysts in trade publications

[FREEDMAN, p. 3]

[Context] Summary of *One Up On Wall Street*, by Peter Lynch with John Rothschild. This book is directed at and provides advice to the individual nonprofessional investor whom Lynch believes can be more successful than the Wall Street trader.

The following approach although oversimplified, is critical to an investor:

1. **[Summary of LYNCH, p. 18]** Examining the investment potential in an investor's own environment or workplace. If a product in a store seems to be highly popular and selling well and that product is a significant percentage of the sales of a relatively small publicly held company, the stock may be an excellent investment and probably is unknown to Wall Street analysts.
2. **[Summary of LYNCH, p. 96]** Performance of a review of a company's fundamentals before a stock selection is made.
3. **[Summary of LYNCH, p. 99]** By putting stocks into categories, i.e., (1) the slow growers, (2) the stalwarts, (3) the fast growers, (4) the cyclicals, (5) the turnarounds, and (6) the asset plays, an investor will have more knowledge about what results to expect.
4. **[Summary of LYNCH, p. 121]** Having an understanding of the basic business and the specific reasons for holding the stock. Generally, a simple business with good fundamentals is a better investment than a complex company. Lynch states,

   > [When somebody says,] "any idiot could run this joint," that's a plus . . ., because sooner or later any idiot probably is going to be running it. **[LYNCH, p. 121]**

5. **[Summary of LYNCH, p. 127]** Looking for companies that institutions don't own.
6. **[Summary of LYNCH, p. 134 and 136]** Everything else being equal, looking for companies (1) that repurchase their own stock, and (2) in which there is insider buying.
7. **[Summary of LYNCH, p. 141]** Recognizing and avoiding "hot stocks."
8. **[Summary of LYNCH, p. 146]** Avoiding "diworseifications." "Diworsefication" is Lynch's description of the propensity for corporations to invest in entities that are overpriced and completely beyond the business expertise and knowledge of the acquirer. Such acquisitions insure the maximization of losses.

9. **[Summary of LYNCH, p. 156 and 163-164]** Giving adequate attention to earnings, assets, and the price/earnings ratio.
10. **[Summary of LYNCH, p. 168]** Finding out how a company plans to increase earnings and periodically checking how the plan is going.
11. **[Summary of LYNCH, p. 172]** Preparation of a two-minute monologue that addresses (1) why an investment is interesting, (2) what must occur for a company to succeed, and (3) any pitfalls.
12. **[Summary of LYNCH, p. 181-184 and 192-196]** Reading the annual report prospectuses, quarterly information, industry trade association reports, company newsletter, and asking insightful questions of a full-service broker if one is used (ask him to give the two-minute monologue).
13. **[Summary of LYNCH, p. 184-190]** Calling or visiting the company and asking for information (just as analysts do).
14. Reviewing some significant numbers in annual reports, such as:
    a. **[Summary of LYNCH, p. 197]** Percent of sales—what percent of total sales is a particularly attractive new product? If it's a small percentage, it won't help the stock price much.
    b. **[Summary of LYNCH, p. 198]** As mentioned previously, the price/earnings (P/E) ratio. Approach a stock with a high (P/E) with caution.
    c. **[Summary of LYNCH, p. 199]** The cash position. If free cash per share is a significant part of the stock market price, the stock may be an excellent investment.
    d. **[Summary of LYNCH, p. 201]** The debt factor. A high long-term debt to equity ratio is a warning sign.
    e. **[Summary of LYNCH, p. 204-207]** Dividend history and relationship to earnings. Dividends relative to the nature of the company.
    f. **[Summary of LYNCH, p. 207]** Book value. It could be a misleading indicator.
    g. **[Summary of LYNCH, p. 209]** Hidden assets. Occasionally, market price doesn't even equal the per-share value of some hidden asset.

h. **[Summary of LYNCH, p. 214]** Analyzing cash flow, i.e. free cash flow. If there is a large amount, "asset buyer" investors will probably find the stock attractive.

i. **[Summary of LYNCH, p. 215]** Inventory. Is there an inventory build-up quarter-to-quarter or year-to-year. Is the build-up automobile's (always worth something) or out-of-fashion miniskirt's (worth nothing)?

j. **[Summary of LYNCH, p. 217]** Pension plans. Do pension fund assets exceed the vested benefit liability?

k. **[Summary of LYNCH, p. 220]** Net income. Investors should look at profit margins. Ideally, a long-term investment should have a relatively high profit margin. A turn-around investment should have a relatively low profit margin.

[Context] Letter sent to the FASB Chairman by an analyst.

> Along with short memories, . . . analysts might sometimes be accused of having short attention spans. Consider that a typical sell-side analyst may have to cover between ten and thirty stocks in some degree of detail; buy-side analysts, probably more but in lesser detail. Analysts are frequently trying to distill a multitude of variables down to the least number of salient facts, either appealing or unappealing (read: "buy" or "sell"). Consider the plethora of newswires and other information that bombards them: they must simplify continually and in so doing, develop short attention spans or be forever lost. [Also included in 18(d)] **[R.G. ASSOCIATES, p. 1-2]**
>
> Now contrast this mindset with that of the Board - where due process counts and projects can gestate for years. Not that there is anything wrong with that - . . . it's the right way to do things and . . . many others [would think so too] (probably the corporate users who are most immediately affected by Board decisions). It's in direct contrast to the analyst's mindset, who is amazed that it takes the Board so long to finish a project that seems to have such an obvious solution (to one who is accustomed to oversimplifying). Long before the Board has finished a project, the analyst has already moved attention to other more pressing matters. Thus, the Board becomes vulnerable to analyst impressions that the only thing that gets them moving is outside political pressure. [Also included in 18(d)] **[R.G. ASSOCIATES, p. 2]**
>
> So far, all [that has been] done is to illustrate what . . . is a common analyst impression of the FASB and explain why . . . it exists; [it is uncertain] how to fix it. It may be irreconcilable; neither parties' nature is likely to change in the future. The fundamental difference in attention spans is a result of the way each party does business. [The FASB] already recognize[s] this because you mention[ed] . . . that responding to proposals simply <u>has</u> to be a lower priority

for users rather than preparers. About the only suggestion [that can be] offer[ed] is to increase the user involvement - and keep it - earlier in the process. The only way . . . to do that is to get [FASB] people into the field more often, and . . . there is a cost to that - in terms of both time and money. [Also included in 18(d)] **[R.G. ASSOCIATES, p. 2]**

1. a. 57 Yet another matter that has created much discussion and controversy over the years is whether the primary purpose of financial accounting and reporting is to fulfill obligations of management accountability or to provide adequate information to help investment and credit decisions. To determine this issue, the survey put this question to the entire sample:

Table 1.7

MANAGEMENT ACCOUNTABILITY VS. INFORMATION FOR INVESTMENT AND CREDIT DECISIONS AS PRIMARY EMPHASIS OF FINANCIAL REPORTING

Q.4A—Let me ask you some questions about the role and function of financial reporting in general. There are different views as to what the *primary* focus of financial reporting should be. One view is that financial reporting should primarily aim at providing information about how management has discharged its responsibility to stockholders for the protection and profitable use of resources entrusted to it.

Another view is that the primary function of financial reporting is to provide information that is useful to present and potential investors, creditors, and other users in making rational investment and credit decisions.

These two views are certainly not mutually exclusive, but they do suggest a question of emphasis. If you had to choose, . . . which of the two views should be given higher priority in resolving financial reporting questions—the management accountability view or the view giving a higher priority to investment and credit decisions?

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Management accountability	31	28	39	39	43	44	23	18	13	27	13	32	21	35
Information for investment and credit decisions	59	58	56	58	39	46	67	73	87	53	80	58	71	59
Both equal	9	14	5	3	14	10	10	9	–	20	7	10	8	6
Not sure	*	–	–	–	4	–	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

Observation: *By a decisive 59-31%, these groups most impacted upon and affected by the setting of financial reporting standards are convinced that information for investment and credit decisions should receive a priority over information fulfilling management accountability to the stockholders. With the sole exception of chief executive officers of private companies, who would give a priority to management accountability, every single other group surveyed believes that it is more critical to give a priority to generating information for investment and credit decisions. Significant is the fact that chief executives of large public corporations hold this view by 58-28%, as do chief financial officers of large public companies by 56-39%. While there are those who feel that the management accountability role is most important, this group is a distinct and clear minority.*

[HARRIS]

1(b). Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to . . . the needs of users. **[FASOversight, p. 1]**

- Comparability and consistency in financial reporting practices over a long period of time, generally 5 to 10 years, is very important in comparing an enterprise's performance and financial position within its industry and across industry lines. [Also included in 2(c)] **[FASOversight, p. 2]**

- Financial information should facilitate assessment of an enterprise's financial position and expected future cash flows. However, no accounting model will provide "scientifically accurate" measures of cash flows, asset and liability values or how such valuations will impact future cash flows. **[FASOversight, p. 2]**

The first objective of financial statements is to provide information that is useful and informative to several classes of financial statement users. Accounting data are the primary means by which readers assess the financial position, results of operations, and cash flows of economic entities. Individual classes of users may require additional data to serve their specialized need, but such data should be furnished by means that are supplementary to the primary general purpose financial statements. [Also included in 2(c)] **[RMA90, p. 3]**

[S]ome observers have argued that investment professionals will generally ignore FAS 106 because the new accrual accounting standard has no effect on a company's current cash flows. Most of the survey respondents, however, take a different view. Just under two-thirds (63%) believe that FAS 106 liabilities represent a significant future cash cost that should be reflected in current equity valuations. [Also included in 1(c)] **[TOWERS PERRIN, p. 2]**

According to the survey, the decision employers make about how—and when—to adopt the new accounting standard will not go unnoticed in the investment community. In general, the survey respondents tend to favor conservative FAS 106 expensing strategies. . . .For example, about half (51%) say the markets will view early adoption favorably. Clearly, early adoption gets the problem out of the way—and gives the investment professionals the information they

want about a company's liabilities and expense. [Also included in 1(c)] **[TOWERS PERRIN, p. 3]**

Similarly, many of the survey respondents (47%) express a positive view of companies that take the transition obligation for past employee service as a onetime "hit," rather than amortizing it. This finding supports the view that investors might be inclined to discount a large onetime charge, particularly because this approach reduces future expense. (For a typical company, taking the hit up front would reduce future annual expense by about 30% and allow the company to show earnings from continuing operations that are more than 10% higher.) [Also included in 1(c)] **[TOWERS PERRIN, p. 3-4]**

Notably, over half (56%) of the survey respondents say "conservative" (i.e., higher than average) medical trend assumptions will be viewed positively. This finding suggests that, although conservative assumptions will tend to depress earnings initially, investment professionals would rather see a company report the "worse case" at the outset—so that future expense revisions, if any, would take a downward rather than upward direction. [Also included in 1(c)] **[TOWERS PERRIN, p. 4]**

Interestingly, the money managers in the survey group express slightly stronger opinions about expensing strategy. Well over half (59%) say they view early adoption favorably, while only 42% of the broker group shared that opinion. The money managers are also more positive about conservative medical trend assumptions: 64% express a favorable view of higher-than-average assumptions, while 52% of the broker group take that view. (The two groups offer similar opinions about companies that take the transition charge up front.) [Also included in 1(c)] **[TOWERS PERRIN, p. 4]**

While the equity experts are clearly concerned about bottom line numbers, the [FAS 106] survey results show that the *actions* employers take to control future costs—i.e., benefit design and funding strategies—will also have an impact on the investment community's assessment of a company's financial position. [Also included in 1(c)] **[TOWERS PERRIN, p. 4]**

Most equity experts recognize that full information on FAS 106 costs won't be available until all companies adopt the new standard during the first quarter of 1993. In the meantime, however, more than three-quarters of the survey respondents (77%) say their firms' equity valuation analyses include an examination of a company's footnoted retiree welfare disclosures. (These disclosures are required by the SEC for annual reports and other financial statements.) [Also included in 1(c)] **[TOWERS PERRIN, p. 5]**

Only about a quarter of the survey respondents (26%) say they use benchmarks in their efforts to estimate the impact of FAS 106. Of those who do use benchmarks, just under half (49%) say they develop liability and/or expense estimates based on a benchmark multiple of current pay-as-you-go costs. Fewer use benchmark reductions in pretax earnings or net worth (28% and 32%, respectively). [Also included in 1(c)] **[TOWERS PERRIN, p. 6]**

[Regarding adoption of FAS 106] in preparing analyses for a specific company, many of the survey respondents (58%) make adjustments for certain company-specific factors. Most of

these equity experts say they look at employee demographics (71%), whether the workforce is unionized (62%) and the nature of the benefit plan (52%). . . .Notably, the brokers in the group look more closely at employee demographics and the benefit plan than the money managers do. Fully 80% of the brokers cite employee demographics as a factor, while 57% of the money managers do; 61% of the brokers say they look at the nature of the benefit plan, while 38% of the money managers cite the plan as a factor. [Also included in 1(c) and 13] **[TOWERS PERRIN, p. 6]**

Whether FAS 106 will have an impact on corporate credit ratings and borrowing capacity remains to be seen. Credit ratings are based primarily on cash flow and financial flexibility. And since neither will be directly affected by FAS 106, the rating agencies are generally inclined to view the new accounting standard as a "nonevent"—at least as far as specific ratings go. [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

In a report released last year, for example, Standard & Poor's (S&P) said that FAS 106 "is not expected to have any widespread impact on debt ratings, since cash flow will not be affected directly." Moody's has also stated that "rating changes are not anticipated" as a result of FAS 106, because "this liability has been factored into our ratings." Moreover, some credit analysts believe that FAS 106 may have *positive* credit implications for some companies, because it encourages them to limit generous retiree medical benefit plans. [Footnote references omitted.] [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

[T]he rating agencies indicate that they will look more closely at retiree welfare liabilities as a result of FAS 106. Moody's say that FAS 106 "will clearly impact the reported financial statements of some companies more than others," and that it "will review carefully the assumptions underlying the numbers." Similarly, S&P says that retiree welfare obligations "represent a substantial and growing burden for many companies" and will therefore subject those liabilities to greater scrutiny. [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

Other market observers believe that companies considered "marginal credits" will feel the effects of FAS 106 more than others. Even without a rating downgrade, "increases in reported retiree medical expenses and the disclosure of the cumulative liability may impair market access and cause new issue borrowing spreads to widen" for these companies. These analysts also expect that some companies may violate net worth or leverage covenants in existing debt agreements as a result of FAS 106. But because issuers are likely to factor FAS 106 into future covenant negotiations, future borrowings may not be affected. [Footnote reference omitted.] [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

Clearly, employers shouldn't expect institutional analysts and investors to overlook the effects of FAS 106. The Towers Perrin survey shows that, despite the temporary information gap, many investment professionals are paying close attention to retiree welfare liabilities and how companies manage them. In fact, a significant percentage of the survey respondents (47%) say that a company's ability to manage retiree benefit costs is a strong indicator of *overall* management effectiveness. [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

Especially critical are the specific strategies companies develop for managing expense and controlling future costs. While the survey demonstrates that earnings from continuing operations is still the most closely watched indicator of corporate performance, equity experts are also influenced by qualitative factors—including management's approach to valuation assumptions, timing, benefit design and funding. [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

The survey results clearly indicate that employers should consider investor expectations when they're making FAS 106 decisions. Expensing strategy is a good example. Following is a closer look at the issues. [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

- Assumptions. FAS 106 allows employers to develop "best estimates" for key expense variables such as interest rates, expected retirement ages and health care cost "trend" (the rate of increase in per capita health care prices and usage). Assumption decisions can, in turn, have a significant impact on the charge against earnings. For example, if a typical manufacturing company lowered its long-term health care trend assumption by 2%, FAS 106 expense would drop by as much as 30%. [Also included in 1(c)] **[TOWERS PERRIN, p. 9]**

- What's the best approach? The investment community won't look favorably on an unexpectedly large expense—either initially, or later if upward revisions become necessary. Many equity experts probably favor conservative assumptions for that reason. On the other hand, minimizing expense is clearly important. [Also included in 1(c)] **[TOWERS PERRIN, p. 9]**

- So the key is to strike a reasonable balance—i.e., an approach that avoids overstating or understating expense. In any case, a company's FAS 106 assumptions, whether conservative or aggressive, should be consistent with management's general approach to financial reporting. [Also included in 1(c)] **[TOWERS PERRIN, p. 9]**

- **Taking the transition 'hit.'** As the survey results show, most investment professionals are more concerned about earnings reductions than reductions in net worth, and many would be inclined to discount large onetime charges. And since charging the transition obligation up front substantially reduces the FAS 106 impact on future earnings, most companies will take that approach if they can afford it—i.e., if net worth is sufficient to absorb the onetime charge. (Those whose initial liability amounts to less than 50% of net worth will generally choose to take the charge.) [Also included in 1(c)] **[TOWERS PERRIN, p. 9]**

Perhaps owing to their skepticism about annual reports, 47 percent of the individual investors said they only skim through annual reports, or don't read them at all. Thirty-three percent reported that they read annual reports, and 18 percent said they study them. **[HILL KNOWLTON, p. 7]**

While 55 percent of the individual sample find annual reports useful to investment decisions, individuals gave annual reports a low rating as a source of information on buying and selling stock -- ranking them next to last among seven information sources. [Also included in 1(c)] **[HILL KNOWLTON, p. 7]**

The individual [investors] listed their own analysis of stocks as an investment first, with 87 percent giving this category a "very important" or "somewhat important" rating. Second with individuals as an investment information source are statistical services, such as Standard & Poor's and Value Line, with an 83 percent importance rating. Interestingly, press articles ranked third, with a 79 percent rating, and radio and television business programs were fourth, with a rating of 73 percent. **[HILL KNOWLTON, p. 7]**

Stockbroker recommendations surprisingly ranked only fifth as an information source [for individual investors], at 70 percent. Annual reports were sixth, with a 66 percent rating, and friends' and relatives' recommendations were seventh, at 49 percent. **[HILL KNOWLTON, p. 8]**

Professional investors consider the annual report essential to their analysis. All 50 [surveyed] said they basically agree with the statement, "As a professional investor, corporate annual reports are essential to me." (One professional agreed, but substituted the word "meaningful" for "essential.") **[HILL KNOWLTON, p. 8]**

Among seven information sources, professional investors ranked annual reports second in importance only to individual interviews with company management. They gave management interviews a 92 percent rating, and annual reports an 80 percent rating. Next were Forms 10-K and other SEC-filed documents, with a 75 percent rating; group analyst meetings with managements, 67 percent; financial factbooks, 65 percent; news media articles, 52 percent; and reports from others in Wall Street, 47 percent. **[HILL KNOWLTON, p. 8]**

While individual and professional [investors] were critical of annual reports, a number of them volunteered that they think annuals are improving. Clearly, some also see the need for further improvement: **[HILL KNOWLTON, p. 8]**

- "Annual reports have come a long way. They're so much better than they ever were." (Philadelphia mutual fund analyst) **[HILL KNOWLTON, p. 8]**

- "They have improved in the past few years. But there is a lack of negative truths. Annual reports protect companies' outlooks." (Chicago investment counseling firm analyst) **[HILL KNOWLTON, p. 8]**

- "Annual reporting is getting better. But they should tell their story accurately, succinctly and clearly. There are too many photographs." (Phoenix bank analyst) **[HILL KNOWLTON, p. 8]**

- "Annual reports have been improving over the years." (Chicago individual investor) **[HILL KNOWLTON, p. 9]**

Of individual investors, 58 percent find annual reports easy to read and understand. Concerning detail, 47 percent said there is enough, 29 percent there is too much, and 14 percent said there is not enough. Only 24 percent of the individual said annual reports are so detailed they can't find out what they want to know. Thirty-four percent are troubled by too much technical and industry jargon. **[HILL KNOWLTON, p. 9]**

[Twenty-seven] percent of the individual investors did say it is sometimes hard to tell from an annual report what business a company is in. **[HILL KNOWLTON, p. 9]**

Professional investors want as much detail from annual reports as they can get. When asked to choose 10 different ways in which annual reports could be useful to them, professionals gave the alternative "disclose as many details and numbers as possible" an 84 percent rating, second only to organizing the report using a business segment format . . ., which had a 91 percent rating. [Also included in 3(e)] **[HILL KNOWLTON, p. 9]**

[P]rofessional investors place a high value on business segment information in annual reports. [Also included in 3(e)] **[HILL KNOWLTON, p. 9]**

[P]rofessionals ranked the item "present the business in a segment-by-segment format" first among the 10 ways in which annual reports could be most useful to them, giving it a 91 percent rating. And in rating the importance of various information items in the annual report, professionals placed business segment information second, with a 93 percent rating, right behind the report's financial statements, which had a 95 percent rating. [Also included in 3(e)] **[HILL KNOWLTON, p. 10]**

The professional investors rated a number of other communications elements used in many annual reports today as less useful to their analysis of a company. This list consisted of: "Use charts and graphs to display quantitative data," 60 percent; "present information that demonstrates the company is a good corporate citizen," 38 percent; "show pictures of management and directors," 26 percent; and "show pictures of production facilities," 22 percent. **[HILL KNOWLTON, p. 12]**

Here is the complete ranking of the . . . ratings investment professionals gave [12] sections of the annual report:

Section	Importance Rating
1. Financial Statements	95 percent
2. Business Segment Information	93 percent
3. Financial Review	87 percent
4. Five- or Ten-year Financial Summaries	87 percent

5. Management's Analysts	81 percent
6. Review of the Year	78 percent
7. Quarterly Summaries	74 percent
8. Statement of Accounting Policies	73 percent
9. Financial Highlights	70 percent
10. Letter to Shareholders	69 percent
11. Dividend Payments (two years)	54 percent
12. Stock Price History (two years)	43 percent

PROFESSIONAL INVESTOR[S'] VIEWS ON THE USEFULNESS OF VARIOUS TYPES OF INFORMATION]

• **Annual reports are most useful to me when they (Rate on a scale of 0 to 10) --**	Percentage Usefulness Rating
A. Disclose as many details and numbers as possible.	84.1
B. Present the business in a segment-by-segment format.	90.8
C. Use charts and graphs to display key quantitative data.	60.2
D. Show pictures of production facilities.	22.3
E. Show pictures of management and directors.	25.5
F. Avoid cliches and jargon.	70.4
G. Describe R&D and product development efforts.	75.6
H. Show clearly captioned pictures of new products and R&D processes.	56.8
I. Present information that demonstrates the company is a good corporate citizen.	37.8
J. Present industry and economic trend data.	76.4

[HILL KNOWLTON, p. 14]

- **Please indicate the importance of various sections of an annual report when assessing a particular company, using a scale of 0 to 10, 10 being most important.**

	Percentage Importance Rating
A. Financial highlights	70.4
B. Letter to shareholders	69.4
C. "Review of the year" section	77.8
D. Financial review section	87
E. Management's analysis	80.8
F. Financial statements	95
G. Quarterly summaries (two years)	73.8
H. Accounting policy statement	73.5
I. Business segment information	93.3
J. Effects of changing prices (inflation accounting)	38.5
K. Five- or ten-year financial summaries	86.8
L. Dividend payments (two years)	53.7
M. Stock price history (two year).	43

[HILL KNOWLTON, p. 15]

Individual and professional [investors'] information needs differ, but more in the level of detail needed than in the types of information needed. For instance, individual investors express a need to see company financial statements, but do not identify the specific data needed. Professionals, on the other hand, express the need to see the company's balance sheet, income statement, cash flow, and quarterly statements. In addition, the professionals place relatively greater importance on quantified information than do the individuals. **[SRI, p. 29]**

Individuals seem to focus their attention primarily on the company itself and secondarily on the environment in which the company operates. In contrast, the professionals appear to have a more integrated view, placing greatest importance on information that sheds light on both the company's performance and the environment influencing that performance. [The following two] tables show the types of information needed by investors and the percentage of the

respondents who consider each type of information important or extremely important. [Also included in 13] **[SRI, p. 29]**

- Individual Investors' Information Needs

Rank	*Type of Information*	*Important/ Extremely Important*
1	Company reputation	78.8%
2	Industry outlook	78.6
3	Company outlook	78.4
4	Company's stock performance	70.2
5	Recent company developments	69.6
6	Company financial statements	67.6
7	Potential risks for company	66.9
8	Historical financial data	57.7
9	Information on company's products	54.5
10	Information on the economy	52.0
11	Brokerage company research	42.5
12	Advice from professionals	42.4
13	Business segment information	39.5

Notes:
1. Findings are based on responses to the question, "For each type of information named, how important is that type of information to you when making a decision to buy or sell a company's stock?"
2. Heavy traders and holders of large portfolios generally rated all information types important or extremely important 10 percent to 15 percent more than the overall averages shown above.
3. There is no statistically significant difference between the first three items on this list, nor between the fourth through seventh items.

Source: SRI International survey, 1986.

[Also included in 13] **[SRI, p. 30]**

- Professional Investors' Information Needs

Rank	*Information Type*	*Important/ Extremely Important*
1	Recent developments and outlook for the company's industry	82.4%
2	Annual company earnings	82.4
3	Company's position in the marketplace	80.4
4	Risks to which the company is exposed	79.8
5	Recent events affecting the company	79.8
6	Annual company financial position or balance sheet information	79.5
7	Annual company cash flow	74.0
8	Company goals and strategic direction	70.2
9	Information on the major business units within the company	67.0
10	Forecasts of company performance	62.5
11	Company stock performance	61.2
12	Information on the company's products	60.6
13	Historical company financial data	58.7
14	Quarterly company earnings	58.7
15	Quarterly company financial position or balance sheet information	57.4
16	Outlook for the economy	49.4
17	Quarterly company cash flow information	46.2
18	Opinions and analyses of the company by other analysts of professionals	35.9

Notes:
1. Findings are based on responses to the question, "For each type (of information), please tell me how important that type of information is to you when analyzing a company or making an investment decision."
2. An additional sixty-nine information elements were specifically mentioned as important by the professionals, none by more than 8.0 percent.
3. There is no statistically significant difference between the first six items on this list.

Source: SRI International survey, 1986.
[SRI, p. 31]

[Individual and professional investors] . . . place low importance on overall economic information, but high importance on information about the company's industry. Economic information seems too general and nonspecific to be useful, while forecasts by economists are viewed skeptically. In contrast, information about the company's industry is deemed

exceedingly important to understand the company's prospects: [Also included in 13] **[SRI, p. 29]**

Interestingly, "quality of management" did not emerge as one of the important types of information—a significant departure from earlier research studies. Although management quality is extremely important to investors, they believe they can best understand it by evaluating performance, reputation, market position, and other company characteristics. In other words, management quality is an inherent and inseparable aspect of the other types of information. [Also included in 13] **[SRI, p. 29-30]**

"Company reputation" is a vague concept, not clearly defined by the individuals, but extremely important to them nonetheless. The professionals see company reputation much the same as they see quality of management. Reputation is intricately woven with numerous other types of information and is not a separate category unto itself. Management likewise understands the importance of reputation. [Also included in 13] **[SRI, p. 30]**

"Company's stock performance" to an unsophisticated investor means long-term price moves and dividend yield. To a semiprofessional, it means security price changes over recent weeks, days, or even hours. [Also included in 13] **[SRI, p. 30]**

"Recent events affecting the company," which was ranked fifth by both individuals and professionals, represents highly situational information. Although timely knowledge of a major event such an acquisition, sharply reduced revenues, a product breakthrough, or major litigation can prove critical to investment decision making, by and large "recent events" is recognized as an information category that normally does not significantly affect the performance of a security; it merely adds to the cumulative store of information about a company: [Also included in 13] **[SRI, p. 30-31]**

"Business segment information" is not particularly important to most individual investors, although these data are relatively important to the professionals: **[SRI, p. 31]**

"Potential risks for the company" are always considered by professionals in their analyses. They want companies to report their own views of the risks they face and how these risks will be managed. Individuals tend to think in terms of a company's past performance and general expectations for the future, but not specifically of risk exposure. When prompted, however, individuals assign high importance to company risk. [Also included in 10(c)] **[SRI, p. 31-32]**

"Forecasts of company performance" was rarely mentioned by individual investors. Professionals wish they could obtain reliable, unbiased forecasts and would rate them much higher, but their experience has shown that company-generated forecasts are overly optimistic. Professionals tend to generate their own forecasts, lacking trustworthy forecasts from other sources. [Also included in 12] **[SRI, p. 32]**

"Company financial statements" are important to all investors, but in different ways. Unsophisticated individual investors understand only a few items in the statements, and even fewer in the footnotes. Even so, they place high value on the small amounts of information

they can extract from financial statements and therefore rate the statements as important. On the other hand, professionals and semiprofessional individuals understand and highly value financial statements. They rank the earnings statement highest, followed by the balance sheet and the cash flow statement (statement of sources and uses of funds). Because they understand that company managements can present financial data in several (more or less favorable) ways, most professionals very carefully evaluate financial statements, paying close attention to the details in the footnotes. **[SRI, p. 32]**

"Company goals and strategic direction" are important primarily to the professionals. They recognize the sensitivity of this type of information—and thus a company's reluctance to disclose it— but they value the insights to be gained from a thorough understanding of a company's plans. They have a similar desire for market share and other competitive standing information, for details of a company's internal cost structures, and for other sensitive information, but they also understand the proprietary nature of these kinds of information. [Also included in 13] **[SRI, p. 32]**

"Brokerage company research" and "advice from professionals" are not types of information at all but sources. Investors revealed, however, that recommendations of competent people and analyses of various kinds are regarded as information types by many. **[SRI, p. 32]**

Both individual and professional investors use the annual report more than any other information source. After annual reports, individuals rely most on newspapers, the *Wall Street Journal*, stockbrokers, and general business publications. Professionals depend on the SEC Form 10K, company quarterly reports, other analysts, and company management. [The following two] tables show the sources most used by individual investors. **[SRI, p. 33]**

Ultimately, all information about a company and its performance originates with the company itself. By the time information reaches the investor it has gone through numerous filters and transformations. The value of information to the investor is thus a function of both its original content and the process it goes through before it reaches the investor. **[SRI, p. 33-34]**

1(b). Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information—Page 13

- Sources of Investment Information for Individual Investors

Rank	*Source*	*Percent Using*
1	Company annual reports	59.3%
2	General newspapers	49.3
3	Wall Street Journal	41.5
4	My broker	28.2
5	General business publications	27.4
6	Personal contacts	26.1
7	Company quarterly reports	20.8
8	SEC filings and prospectus	14.9
9	Investment information services	14.7
10	Brokerage firm analysis/reports	13.0
11	Trade association/publications	7.1
12	My investment advisor	6.6
13	Television	5.7
14	Company press releases	5.4
15	Investment letters	4.5
16	SEC Form 10K	3.6
17	Proxy statement	2.8
18	SEC Form 10Q	2.8
19	Shareholder meetings	2.0
20	Radio	1.2

Note: Other sources with less than 1.0 percent usage were product brochures, company employees, company officers, investor relations programs, company advertising, computer data services, accountants, personal research efforts, attorneys, bank officers, financial planners, and libraries.

Source: SRI International survey, 1986.

[Also included in 1(a)] **[SRI, p. 33]**

- Sources of Investment Information for Professional Investors

Rank	*Source*	*Percent Using*
1	Company annual reports	84.6%
2	SEC Form 10K	62.2
3	Company quarterly reports	57.4
4	Other analysts or professionals	54.8
5	Company management	53.8
6	Investment information services	47.1
7	SEC Form 10Q	44.2
8	Company press releases	42.6
9	General business publications	37.2
10	General newspapers	34.0
11	Wall Street Journal	32.1
12	Trade associations/publications	26.6
13	Company fact books	17.6
14	Personal contacts	17.6
15	Analyst meetings/presentations	16.0
16	SEC filings/prospectus	12.8
17	Other analysts in my own firm	12.5
18	Investment letters	11.2
19	Company competitors	10.3
20	Proxy statements	9.6
21	Wire services	6.4
22	Company customers	5.1
23	Government reports/publications	4.8
24	Company suppliers	3.2

Note: All other sources had no more than 1.6 percent usage and included speeches and interviews of company officers, product literature, rumors, employee publications, Quotron, industry seminars, shareholders, credit reports, and former employees.

Source: SRI International survey, 1986.

[Also included in 1(a)] **[SRI, p. 34]**

Investors value each source of information based on its objectivity, content, accessibility, and timeliness. These components are not weighed explicitly, but valued subjectivity, depending on individual abilities and preferences. **[SRI, p. 34]**

Virtually all investors want unbiased, candid, unembellished investment information. They do not want sales pitches from brokers, optimistic expectations (or self-serving excuses) from company management, or information distorted by inappropriate interpretation and analysis. Most investors, especially the professionals and the semiprofessional individual investors,

think that they can spot biases; some believe that they can filter out the biases to reach some degree of objectivity. If they cannot eliminate the biases for themselves, they place high value on information sources that can do so, either analytically or based on experienced judgment. [Also included in 1(c)] **[SRI, p. 34-35]**

Many sources provide a minimum of content, such as listings of stock prices or brief descriptions of product lines; others contain dozens of pages of densely packed facts, opinions, and analyses; and some merely provide advice and guidance with few data. Investors perceive the value of these sources based on their individual decision style and their requirement for information content of one or a combination of the following three kinds: **[SRI, p. 35-36]**

- Data—raw facts unprocessed by analysis or human judgment. **[SRI, p. 36]**

- Analysis and interpretation—information that has been processed and improved through analysis, condensation, interpretation, or reformatting. The investor must perceive this process as valid and as applied with competence. **[SRI, p. 36]**

- Guidance and advice—opinions and recommendations that are useful for investment decision making. The value of this kind of information depends on the perceived competence and reliability of the source. **[SRI, p. 36]**

Investors do not have equal access to information; some do not even know of the existence of many information sources. The cost of information, in terms of money, time, and effort, is a significant factor in its perceived value. **[SRI, p. 36]**

Some information sources are valued for their timeliness. The major component of the value of wire services, for example, is their timeliness. **[SRI, p. 36]**

If a company wishes to influence the behavior of its investors or potential investors, it must know which information sources are most valued by investors and hence most influential. Of all the sources used, professional investors identified company management, fellow analysts, and the SEC Form 10K as "most useful" to them in investment decision making. Individual investors found that their investment advisor, brokerage firm analysts, and broker were most useful. The results are summarized in [the] table [below]. **[SRI, p. 36]**

Importance of Information Sources

Individuals			Professionals		
Rank	*Source*	*% Most Important*	*Rank*	*Source*	*% Most Important*
1	My investment advisor	89.4%	1	Company management	67.3%
2	Brokerage firm analyses/ reports	66.2	2	Other analysts in my firm	64.0
3	My broker	64.9	3	SEC Form 10K	60.3
4	Investment information services	57.8	4	SEC filings/prospectus	55.5
5	SEC Form 10Q	53.6	5	Company annual reports	55.3
6	SEC Form 10K	52.8	6	Wire services	54.7
7	General newspapers	49.5	7	Government reports/ publications	54.2
8	Wall Street Journal	46.3	8	Company competitors	52.4
9	Personal contacts	45.6	9	Other analysts or professionals	52.0
10	SEC filings and prospectus	42.3	10	Company customers	51.0
11	Company annual reports	37.3	11	Company suppliers	50.0
12	Company quarterly reports	36.1	12	Company fact books	49.4
13	Trade associations/ publications	35.2	13	Investment information services	48.4
14	General business publications	31.8	14	Trade associations/ publications	48.1
15	Company press releases	25.9	15	SEC Form 10Q	47.1
16	Investment letters	20.0	16	Personal contacts	42.0
17	Shareholder meetings	15.0	17	Analyst meetings/ presentations	41.9
18	Proxy statements	14.3	18	Company quarterly reports	36.9
19	Television	14.0	19	Proxy statements	30.2
20	Radio	8.3	20	Wall Street Journal	25.9
			21	General business publications	25.8
			22	Company press releases	23.2
			23	General newspapers	22.6
			24	Investment letters	8.9

Source: SRI International survey, 1986. **[SRI, p. 38]**

"Most used" does not correlate with "most useful." When a source is inexpensive and easy to get, it is widely used even though it may not be very useful. To the few individual investors who use them (6.6 percent), investment advisors are highly important. Corporations do not consider them a productive conduit of information to the individual investor community, however, because they are so infrequently used. Stockbrokers, not surprisingly, are both influential (useful) and used by a significant 28.2 percent of individual investors. Surprisingly, SEC Forms 10Q and 10K appear high on the "most important" list, although many individuals do not even know what they are. These items are used primarily by the semiprofessional segment who value them for their information content and government-supervised objectivity. The general information source preferences of each investor segment are discussed below. **[SRI, p. 36]**

Buy-and-hold investors rarely trade their securities, know little about securities markets, and are not confident about their investment competence. They want highly processed information and the advice of individuals whose competence they acknowledge. They value easy access (low cost and convenience) and content, specifically, advice and guidance. Hence, they place greatest value on information provided by investment advisors, brokers (individual stockbrokers and brokerage house reports), and investment information services. **[SRI, p. 37]**

Opportunity-driven investors are alert for investment opportunities; the timeliness of information takes on greater importance with this segment. If they perceive a potential opportunity, they seek more information and confirmation from sources with greater content. **[SRI, p. 37]**

[Opportunity-driven investors] use a greater variety of information sources than other individual investors, but they particularly value investment advisors, brokers (both individual stockbrokers and brokerage house analysts), and investment information services. Additionally, for scanning purposes, they tend to rely on easily accessible, timely sources such as newspapers, the *Wall Street Journal*, trade publications, and investment newsletters. **[SRI, p. 37]**

This highly sophisticated, self-confident segment is more selective in its use of information sources, placing highest value on content and timeliness. For them, access is not an issue (they know what sources they want and how to get them, and the cost is no deterrent to this affluent segment). Objectivity is also not a problem because these investors feel competent to penetrate the biases in such nonobjective sources as annual reports. This segment places highest value on investment information services, brokerage house reports and analyses, selected highly competent personal contacts, and knowledgeable stockbrokers. From these data, the semiprofessionals then make independent decisions. **[SRI, p. 37]**

The buy-siders place the highest value on data and competently processed information and analyses. The timeliness of information about key events is critical. Access and objectivity are also important, but are not issues for this segment. Using current information provided by their firms, they believe they can arrive at relatively unbiased conclusions. Buy-siders rely most heavily on annual reports, on contact with company managements, and, interestingly, on

other professionals. Sell-side analysts are an important source of information to them. **[SRI, p. 37&39]**

Sell-side analysts are highly visible in the marketplace; many have national reputations in the financial community. Their greatest information need is for reliable raw data and lots of it. They are the most voracious users of investment information and the most independent decision makers, decisions being equated with recommendations in this case. They value content above all and rely on annual reports, SEC Forms 10K and 10Q, SEC filings, company fact/data books, trade publications, and contact with company management. **[SRI, p. 39]**

Being sales oriented, brokers value highly credible content, specifically objectivity, analysis and interpretation, and guidance and advice. They also favor information packaged for selling. They place highest value on annual reports (despite a perceived lack of objectivity), analyst's reports, investment information services, analyst's presentations and meetings, and contact with company management (for the institutional sales representatives, who have access to management). **[SRI, p. 39]**

Not only is the annual report one of the most readily available of sources, and certainly a low-cost source to users, but it has the most nearly comprehensive coverage of the types of information most needed by investors. Yet, the annual report has no role in the securities purchase decisions of most individual investors, and only a limited role in the decision to sell securities. It serves primarily as a reference document and, for many, a source of reassurance about their investments. Individual investors rarely even see the annual report until after they own a company's securities. The report is somewhat more important for the semiprofessional individual investors, whose analytical decision-making styles draw from data and financial information found in the annual. [Also included in 1(c)] **[SRI, p. 51]**

Professional investors are influenced to a greater degree by the annual report, although it still ranks only fifth in its importance to them. As with the individuals, the annual report is the most used source but not the most useful source. Virtually all professionals state that they always obtain both the annual report and SEC Form 10K prior to making investment decisions. Professionals complain, however, that companies often provide professionals with annual reports, but not with 10Ks--a careless omission in their view. [Also included in 1(c)] **[SRI, p. 51]**

Professionals discard about one-third of the annual reports they receive. Those they keep they use as reference sources for analysis and report writing. On average, each professional receives 324 annual reports per year, with sell-side analysts receiving 439, the buy-side professionals 343, and the brokers 187. [Also included in 1(c)] **[SRI, p. 51]**

Very few investors read the entire annual report when they receive it, although professionals eventually read all the annual reports on companies they follow. Reading patterns are highly selective, either focused and directed in the case of sophisticated investors who know the information they want and who specifically seek it out in the annual, or less focused for those who go through the report more casually, reading in depth those items that attract their

interest. When asked what they do with annual reports when they arrive, investors provided the responses shown [below]. [Also included in 1(c)] **[SRI, p. 52]**

Reading the Annual Report

Action	*Individual Investors*	*Professional Investors*
Throw it away without reading it	3.9%	(not asked)
File it or save it without reading it	3.0	9.4%
Skim the whole report to get a general impression of the company	27.0	21.7
Glance through it, stopping to read what attracts attention	34.5	29.8
Seek out specific items of information	22.7	33.4
Read the entire report	8.6	5.0

Note: Findings are based on responses to the question, "Which of the following statements most nearly describes the way you read an annual report when you first receive it?"
Source: SRI International survey, 1986. [Also included in 1(c)] **[SRI, p. 52]**

"Reading," to most individuals, seems to include casually looking over the material and drawing some meaning, however, small, from it. To the professionals, reading means going through all the material and paying close attention to it. What the professionals call reading, the individuals might call studying. [Also included in 1(c)] **[SRI, p. 52-53]**

Professionals read annual reports in two different ways and at different times. When they first receive annual reports they glance through them, reading a few items of interest; then they either discard the reports or keep them for future reference. Later, the annual reports that were retained are read and analyzed in considerable detail. [Also included in 1(c)] **[SRI, p. 53]**

Individual investors are not nearly as aware of the various parts of the annual report as are the professionals. Individuals tend to think in terms of the front and the back of the annual. The front, consisting of the narrative part of the report, is generally understandable, although not always useful or interesting. The back, consisting of "the numbers," is generally considered important, but not very comprehensible. While not always familiar with specific parts of the annual, individuals have formed opinions on their importance for decision making. The professionals, on the other hand, discriminate easily among the various parts of the annual and find them all understandable. [Also included in 1(c)] **[SRI, p. 53]**

[The] table [below] shows the importance of various parts of the annual report to both individuals and professionals. Being selective in their reading patterns, professionals focus on those parts of the annual report providing the most relevant information. In virtually all

instances, the professionals read the financial statements and the footnotes, while paying varying amounts of attention to the other sections. [Also included in 1(c)] **[SRI, p. 53]**

Importance of Annual Report Sections

	Individual Investors			*Professional Investors*	
Annual Report Section	*Percent Who Read This Section*	*Percent of Users Rating Important or Extremely Important*	*Rank*	*Percent of Users Rating Important or Extremely Important*	*Rank*
Income statement	84.9%	78.6%	1	94.2%	1
Balance sheet	82.1	75.0	2	90.1	2
Footnotes to financial statements	51.4	42.9	8	80.4	3
Sources and uses of funds	74.6	72.7	3	76.3	4
Historical operating results	70.3	46.2	7	69.6	5
Quarterly reports	65.5	39.7	9	68.3	6
Financial highlights	82.3	57.2	4	65.7	7
Divisional or business segment reviews	56.6	55.3	5	63.1	8
Management's review	76.1	51.1	6	56.7	9
Chairman's/president's letter	77.8	31.4	12	45.8	10
General company and product information	63.5	33.3	11	44.9	11
Auditor's/CPA's opinion	55.6	34.9	10	39.4	12
List of officers and directors	59.4	19.8	13	19.2	13

Source: SRI International survey, 1986. [Also included in 1(c)] **[SRI, p. 54]**

Individuals often recognize the importance of sections they might not fully understand and value what little meaning they can extract from those sections. For that reason, even the many individuals who profess not to understand much of the income statement, for instance, place high importance on that statement. Furthermore, they seek interpretation about the company's earnings stream from the other information sources they use and from advisors whose competence they trust. [Also included in 1(c)] **[SRI, p. 53]**

Somewhat surprisingly, individual investors rate the financial statements as more important than the narrative, less quantitative parts of the [annual] report, for several reasons. Primarily, of course, is the fact that financial performance is most clearly stated in numerical terms--a

few simple terms for unsophisticated investors, plus numerous complex and abstract terms for sophisticated investors. For all their variation and occasional inaccuracy, numbers convey an impressions of precision and clarity. The narrative parts of the annual report convey less precision, give more latitude for interpretation by the reader, and allow more room for manipulation by the writer. Importantly, the numbers in the annual report are known to be more closely reviewed by outsiders, specifically, the CPA firm conducting the audit and presenting its findings in the auditor's opinion included in each annual report. In addition, the SEC requires annual reports and other corporate communications to meet certain standards of disclosure. Finally, virtually all investors understand that financial statements are governed, however imperfectly, by accounting principles and conventions. None of these disciplines is believed to be infallible, but few comparable disciplines are applied to the narrative parts of the annual report; hence, the narrative portions are felt to be less reliable sources of information. [Also included in 1(c) and 13] **[SRI, p. 53&55]**

In their use of annual reports, semiprofessional individual investors behave more nearly like the professionals than like the other investors. They generally score all parts of the annual higher, and their importance ratings reflect a pattern similar to that of the professional analysts. [Also included in 1(c)] **[SRI, p. 55]**

The four lowest ranked parts of the annual report are the same for both professionals and individuals. These are the chairman's/president's letter, general company and product information, the auditor's/CPA's opinion, and the officer and director information. [Also included in 1(c), 13, and 17(f)] **[SRI, p. 55]**

Issuers of annual reports inaccurately stress the importance of the chairman's/president's letter. Annual report issuers consider the chairman's/president's letter to be the most important part of the annual report, especially for individual investors. Investors themselves, however, tell us that while they frequently read the CEO's letter, they rarely consider it important for decision making. [Also included in 1(c)] **[SRI, p. 55]**

Most individual investors do not know much about footnotes; many find them arcane and undecipherable. Even so, a slight majority (51.4 percent of those receiving annual reports) do "read" them. The only segment of individuals to ascribe a high level of importance to footnotes is the semiprofessional segment; 68.5 percent of them read the footnotes, and of those 60.0 percent consider them important. Furthermore, only about a quarter of all individual investors agree with the statement. "I have to read the footnotes to the financial statements to get an accurate picture of a company's performance"; nearly half of the semiprofessionals agree with that statement. [Also included in 1(c)] **[SRI, p. 55]**

Professional investors, of course, are much much more knowledgeable about and place greater importance on footnotes. Most agreed with the statement, "I have to read the footnotes to the financial statements to get an accurate picture of a company's performance" (only 8.7 percent disagreed). Their ranking of footnotes as the third most important part of the annual report puts footnotes only behind the financial statements they explain, the income statement, and the balance sheet. [Also included in 1(c)] **[SRI, p. 55-56]**

Investors made several observations about footnotes that might be of assistance to users:

- Extraordinary items are often insufficiently explained, even in footnotes. **[SRI, p. 56]**

- The "accounting principles" footnote, while having the appearance of boilerplate, is actually quite important to understanding financial statements. **[SRI, p. 56]**

- Business segment information is often (some said usually) poorly reported. Either important details are omitted, or the business segments reported do not coincide with the way the business is actually conducted. [Also included in 3(a)] **[SRI, p. 56]**

Although quarterly reports are not, strictly speaking, part of the annual report, they are regarded by most investors as a kind of "interim annual report." Quarterlies are flawed in many ways, but because they are more timely than annuals, they are important to investors who trade securities with some frequency; 55.5 percent of the semiprofessional individuals and 68.3 percent of the professionals rated quarterlies as important or extremely important, compared with only 38.2 percent of the other investor segments. [Also included in 11(e)] **[SRI, p. 57]**

Professionals complain about the inadequacy of quarterly reports and the absence of information on extraordinary items (e.g., losses, write-offs, sales of assets) and on results from continuing operations. In particular, many professionals decry the quarterly report's lack of detail (e.g., reporting sales and earnings without the cost components), which is especially frustrating because the detailed information is known or earnings could not have been reported. [Also included in 11(e)] **[SRI, p. 57]**

Financial reports are important but not dominant providers of fundamental information [for sell-side analysts.] Discussions with management seem to users a most important source of information for analysts, although somewhat underplayed by them. Some analysts reports largely are transcriptions or summaries of a management presentation. One analyst reported on a "conference call" to discuss earnings with management and other analysts. Another reported on presentations and discussions at a company's annual meeting. [Also included in 1(c)] **[PREVITS, p. 11]**

A standard, if somewhat simplified, approach taken by most analysts in forming recommendations is as follows. Disaggregate the company's operations into as fine a set of operating units as possible and develop earnings forecasts for each unit. This reduction is much finer than GAAP. For example one report commented that a company "reports two lines, but there are actually three". Analysts regularly discuss the above matters with respect to each operating unit. For example, one waste removal company was analyzed by individual landfills; a gaming company was analyzed by individual casinos, etc. [Also included in 1(a), 1(c), and 3(e)] **[PREVITS, p. 12]**

Analysts tend to employ annualized data but . . . [it is] inferred that they prefer more timely data whenever available. They employ a "rolling" four quarter analysis to annualize data as soon as the new quarterly data appears. Whether or not the issues related to so-called "4th

quarter adjustments" taken at fiscal year end are properly anticipated is not clear. [Also included in 1(c) and 11(e)] **[PREVITS, p. 12-13]**

Of course sell-side financial analyst reports contain extensive nonfinancial information. The nature and recent history of the company, its products, product pricing (particular pricing changes or promotions), customers, suppliers, industry, the national and international economy, and the company's competitive position (especially market share) are common issues. Market related phrases such as "customer(s)", "market(s)", "demand", "economy", and "competitive" occur approximately 9,500 times. A company's production capabilities, technologies, and marketing and distribution system are often evaluated. This includes new information systems for inventory management, order processing, product design, marketing and sales, etc. Superior production technologies are usually given extensive coverage. Expenditures for research and development, including basic research, are evaluated. [Also included in 13] **[PREVITS, p. 13]**

The quality of management is regularly addressed [by sell-side analysts]. More attention is given to management when major changes in management have occurred, and in such cases there are considerations of anticipated changes that the new management will bring. It is common to see references to specific key personnel. Some reports discuss the organizational structure of the company. However, management compensation or bonus provisions are rarely discussed. [It is] interesting that there was no trend to provide "pay for performance" analysis. Labor productivity is also infrequently addressed [by sell-side analysts]. However, upcoming labor union negotiations are noted. [Also included in 13] **[PREVITS, p. 13]**

Analysts extensively disclose and evaluate corporate and management strategy (revenue growth, cost management, marketing strategy, competitive positioning, etc.). Analyst use code phrases in such cases, for example, reporting that "we believe that management is focused on shareholder value." Analysts frequently appraise a company's competitors, and rank an individual company with its competitors on the themes above. Similarly, the potential effects of new, competing products or technologies are discussed, as well as the potential entrance of other companies as competitors. [Also included in 13] **[PREVITS, p. 13-14]**

Additional analysts interests include:
(1) withdrawal of a public offering
(2) significant litigation or negotiation over contract settlements,
(3) long-term contracts, and
(4) regulatory issues. [Also included in 13] **[PREVITS, p. 14]**

The effect of product changes or new products, even when not yet marketed, are almost always assessed [by sell-side analysts], particularly as to the company's ability to compete, and upon competing products, projected demand, revenue, and costs. [Also included in 1(c) and 13] **[PREVITS, p. 14]**

Major projects, including modernization, acquisition, expansion, divestiture, and restructuring plans are evaluated [by sell-side analysts], and their estimated effects are also used in forecasting future performance. Major expenditures on plant, property and equipment are

evaluated, particularly in terms of product costing and capacity expansion. Downsizing plans, and plans to reduce the size of the labor force, are also addressed by the analysts. Analysts also report on the effect of share repurchase plans and planned issuances of new securities. [Also included in 1(c) and 13] **[PREVITS, p. 14]**

Phrases which focus on acquisition occur about 1,500 times in [sell-side analysts'] equity reports studied. Acquisitions are studied in several pro forma dimensions, including earnings and cash flow effects of financing the acquisition, the strategic fit, scale economics, and earnings contribution. [Also included in 1(c) and 13] **[PREVITS, p. 14]**

Finally, analysts use recent and proposed PP&E expenditure levels as a measure of the quality of the company's assets. They evaluate the effect of new contracts (particularly long term) and licensing agreements on EPS. [Also included in 1(c) and 13] **[PREVITS, p. 14]**

Discussion of income statement items dominate equity sell-side analyst reports. Income statement related terms or phrases appear nearly 60,000 times in the full sample, far more frequently than references to balance sheets terms (c. 16,000) or cash flow terminology (c. 6,000). Earnings, earnings per share, profit[ability], and net income are the most frequently occurring income statement terms. **[PREVITS, p. 15]**

[Equity sell-side analysts'] attention . . . is given to revenue change, particularly as a result of product pricing, volume, and demand, and product mix. Production and sale volume information is analyzed. Expenses are only analyzed at a general level usually in terms of "margins", (c.4,200 times), or less frequently in terms of "operating costs", or "SG&A expenses." [Also included in 1(c) and 13] **[PREVITS, p. 15]**

[Equity sell-side analysts give] more detailed attention to noncapital expenditures sometimes . . . in the areas of research and developments expenditures, depreciation, materials and labor. Consistent with their general approach, analysts often estimate expenses by operating unit (segment) and sources of possible cost efficiencies are noted. Relative cost levels are compared across companies and management efforts to reduce costs are noted and evaluated. [Also included in 1(c) and 13] **[PREVITS, p. 15]**

Most [equity sell-side analysts'] reports contain both historical and forecast quarterly and annual income statements or summary information. The most common approach to estimating future EPS is to disaggregate the company into its constituent LOB's and/or geographic regions (both of which are frequently more detailed than GAAP requires), and to then develop forecasts of the performance of individual units which are reaggregated for a company EPS estimate. [Also included in 1(c), 3(b), and 11(e)] **[PREVITS, p. 15]**

[O]perating revenues and expenses are often assessed [by equity sell-side analysts] for individual segments of a company. Performance analysis by significant product or individual location is common. For example, analysts may evaluate the performance of hotel companies in terms of specific U.S. or international geographic regions, or even specific hotels, while mining companies are evaluated in terms of individual mines. Similarly, consumer goods manufacturers are often evaluated in terms of their individual product lines or products. Some

analysts carefully consider the effect on the entire company, industry, and economy as well as revenues and costs in forecasting the results for each reporting unit analyzed. [Also included in 1(c) and 3(e)] **[PREVITS, p. 15]**

A principal approach of many [equity sell-side] analysts for estimating a company's earnings per share involves the disaggregation of the company into as fine a set of reporting units as possible, followed by an earnings analysis and reaggregation. Segment related phrases appeared more than 20,000 times in the selected reports. This frequency was larger than any other grouping of related words and phrases except for income statement related phrases. Analysts use a variety of phrases to refer to the operating units of corporations, including "lines", "areas", "businesses", "divisions", "units", "segments", and "subsidiaries". [Also included in 1(c) and 3(e)] **[PREVITS, p. 15]**

[Equity sell-side] analysts employ a literal definition of nonrecurring income statement items, which are usually referred to as "one time" items. They take notice of reported nonrecurring items as listed below continuing operations and also note the effect of new accounting rules. One report contained a section entitled "Non-operating earnings - A Source of Confusion in the Past". [Also included in 1(c), 5(a), and 5(d)] **[PREVITS, p. 15]**

[Equity sell-side analysts] also identify "potential" nonrecurring items contained in continuing operations, and often report EPS net of these items, as in the case of the analyst who noted "several unusual items" included in continuing operations. Correspondingly, a number of analysts report operating earnings per share, which of course is not required under GAAP, or compute an "adjusted earnings" number which includes all items judged to be nonrecurring, and corresponding EPS. Restructuring charges are an example of one common item often removed in analysts EPS reports. Occasionally analysts identify a nonrecurring cost but are unable to estimate an amount. In one case an analyst was unable to determine the amount of a corporate relocation charge buried in continuing operations. In another report the relocation charge of the company was identified in continuing operations and removed in calculating EPS. [Also included in 1(c), 5(a) and 5(d)] **[PREVITS, p. 15-16]**

[Equity sell-side] analysts discuss a company's "earnings power" or "earnings momentum". One report, for example, commented on a firm's "strong accelerating growth". This appears to be something different than the earnings growth rate reported, which is linear, and suggests a nonlinear growth component. [Also included in 1(c)] **[PREVITS, p. 16]**

The "stability" of a company's earnings is addressed by [equity sell-side] analysts who frequently assess the degree of uncertainty of future earnings, often in terms of "risk". Analysts do not, however, provide explicit evidence that they identify discretionary accruals of management to smooth income. One the other hand, as noted in the discussion of "earnings quality", analysts are attentive to some accruals. [Also included in 1(c) and 10(d)] **[PREVITS, p. 16]**

[Equity sell-side] analysts occasionally report Beta [the relative volatility of the particular stock to the market in general], but almost never discuss it. **[PREVITS, p. 16]**

[Equity sell-side] analysts define "earnings quality" differently than [was] expected. To financial analysts, a company with high earnings quality is one that uses very conservative accounting principles; for instance a company that has accrued reserves against future losses, write downs, etc. One analyst, for instance, reported earnings quality as high when a firm had an "aggressive" policy towards establishing reserves. Another substantiated an assertion of high earnings quality for a company by stating that "the company is over-accruing foreign taxes as a way of managing earnings." A third supported its assertion of high quality earnings by noting that "the opportunity to 'manage down' earnings exists". A fourth argued that a financial company's earnings were more 'credible' because the company applied "more aggressive accounting" methods in writing down assets. [Also included in 1(c) and 5(a)] **[PREVITS, p. 16]**

This suggests a possible analyst preference for secret reserves. [Also included in 1(c) and 5(a)] **[PREVITS, p. 16]**

[Sometimes,] earnings quality . . . seem[s] to be related to "representational faithfulness," and management's forthrightness in disclosure. For example, one analyst reported that an extreme drop in the reported tax rate of a company "caused some to doubt the quality of (its) earnings". Another expressed concern about earnings quality on the basis of the amount of costs included by a company in the determination of cost of goods sold. [Also included in 1(c), 2(b), and 5(a)] **[PREVITS, p. 16]**

Other income analysis factors:

- Analysts see a "strategic acquisition" to be one which reduces a company's short term earnings but increases longer term earning potential.
- Analysts report sales backlog (at company or operating unit levels) and use these as a basis for estimating future performance.
- Average tax rates are calculated for most companies with income data on a comparative and trend basis. Current and deferred portions of income tax expense are often disclosed.
- Regulated companies reported "statutory" or regulatory income compared with GAAP income. [Also included in 1(c) and 5(a)] **[PREVITS, p. 16]**

The balance sheet receives far less attention than the income statement [by equity sell-side analysts], and the occurrences of balance sheet type words and phrases occur far less frequently [in analysts' reports]. Much of the attention to balance sheet items comes in the form of liquidity and cash flow analysis. For example, reports may assert balance sheet strength on the basis of a company's free cash flow. While several income statements are almost always presented, many reports contain only summary balance sheets. [Also included in 1(c), 5(b), and 5(c)] **[PREVITS, p. 17]**

Long term productive asset values on the balance sheet are nearly always evaluated at cost [by equity sell-side analysts]. The effect of inflation on such assets rarely is explicitly considered. However, for some companies, a supplemental analysis of assets' market value is conducted. This is undertaken for firms analysts consider to be poorly understood by other analysts and

investors, and particularly where latent significant off-balance-sheet or hidden assets may exist. [Also included in 1(c), 4, and 5(b)] **[PREVITS, p. 17]**

[A]nalysts asserted that a cable television company had substantial off-balance-sheet assets in the form of residual payments to be received in the future. They calculated the value of the company using several methods, one being the present value of the anticipated cash flows from these residuals. One analyst stated that "balance sheet recognition of . . . hidden asset values . . . will occur in future years". Other examples include inventory and reserve valuations of extractive industry companies. For instance, in gold mining companies, a market value appraisal is included of the reserve values by ore type. [Also included in 1(c), 4, 5(b), and 5(c)**[PREVITS, p. 17]**

[Equity sell-side] analysts periodically examine the quality of assets, particularly in troubled industries such as banking and insurance. Here, attention is paid to nonearning assets, non-performing assets, and the quality of assets (loan portfolios) and investments. [Also included in 1(c) and 5(b)] **[PREVITS, p. 17]**

Liabilities are usually addressed in a summary fashion, often in a simple analysis of the capitalization of the corporation. Extensive attention to liabilities usually only occurs for companies that are highly leveraged and typically in conjunction with a cash flows analysis. [Also included in 1(c), 5(b) and 5(c)] **[PREVITS, p. 17]**

Cash flow analysis [by equity sell-side analysts] displays considerable variety in format and content. Many reports present and/or discuss cash flow extensively. Cash flow information is sometimes presented by segment or operating unit. Some reports make no mention of cash flow at all. Cash flow type phrases occurred about 6,000 times in the full sample. [Separately, dividends are mentioned over 2,000 times.] [Also included in 1(c), 3(c), and 5(c)] **[PREVITS, p. 18]**

Although cash flow per share calculations are not permitted in audited filings under SEC rules nor by SFAS 95, cash flow per share and operating cash flow per share are almost always calculated by analysts when they provide any cash flow data. Analysts also calculate "fully diluted cash flow per share" and some provide "distributable cash flow per share", "excess cash flow per share", "discretionary cash flow per share", and "free cash flow per share." [Also included in 1(c) and 5(c)] **[PREVITS, p. 18]**

Some [equity sell-side] analysts compute a price to cash flow ratio, and present a comparison of this ratio with other companies in that industry. Others assess the relationship between cash flows and earnings. For example one report stated that the value of a company was "compelling" because "operating cash flows are 4.3 times 1990 earnings". Another analyst encouraged purchase of a major tobacco company's stock because of its "tremendous surplus cash flows". [Also included in 1(c) and 5(c)] **[PREVITS, p. 18]**

Cash flows seem to be more important to [equity sell-side] analysts in evaluating smaller companies, and less so in evaluating larger companies, with the exception of highly leveraged larger companies or ones in which a dividend cut is possible. One report, for example, states

that "The important figure . . . for evaluation of smaller petroleum . . . companies is operating cash flow per share." Another stated that in comparison with cash flow "historical financial results of [the company] are irrelevant". [Also included in 1(c) and 5(c)] **[PREVITS, p. 18]**

Examples of unorthodox cash flow formats [presented by equity sell-side] analysts in addition to free cash flow and discretionary cash flow arrangements are: [Also included in 1(c) and 5(c)] **[PREVITS, p. 18]**

Net income
+/- all effects except cash interest
= cash flow available to common
- cash interest
= net cash flow

Direct operating cash flows
- priority outflows
- discretionary outflows
+ financial inflows
= change in cash

[Also included in 1(c) and 5(c)] **[PREVITS, p. 18]**

It was also intriguing to discover an example where the "foreign exchange cash flow" in a statement of cash flows was presented outside the three traditional categories of the SFAS 95 format. [Also included in 1(c) and 5(c)] **[PREVITS, p. 18]**

[Equity sell-side] analysts distinguish between valuations based upon the company's continued existence in its present form: so called fundamental value, and valuations based upon acquisition or breakup of the company. Analysts use several approaches to valuing companies based on fundamentals, most typically in terms of the present value of the company's cash flows, its earnings, or balance sheet valuations. In this approach analysts also distinguish between a company's "Public market value" and "private market value". For example, one analysts measures the fundamental value of a company in terms of:

1) Private market value
2) Price/revenues
3) Price/book value
4) Price/long-term earnings
5) Growth-driven valuation composite
6) Contrarian composite [e.g. Bearish Sentiment Indicators]
7) Earnings momentum composite
8) Technical ranking
9) Beta

[Also included in 1(a), 1(c), and 4] **[PREVITS, p. 19]**

Another analyst valued companies in terms of revenue, cash flow multiples, and net income. And yet another analyst valued a cable TV company with purported off-balance-sheet assets on three basis:

1) present value of cash flows,
2) appraised value of assets and
3) the company's liquidation value.

[Also included in 1(a), 1(c), and 4] **[PREVITS, p. 19]**

Another analyst evaluated the same cable TV company by analyzing each of the many limited partnerships with which the company was related in order to estimate the long-range cash flows of each to the company. [Also included in 1(a), 1(c), and 4] **[PREVITS, p. 19]**

Analysts label valuations of a company based upon it acquisition or breakup as it "buyout value", "breakup value", "takeover value", "theoretical breakup value", and so forth. Examples of computed break up value include the following:

1) Estimated breakup value = asset values at market price less liabilities.
2) Adjusted breakup value takes the above and adds other "likely" assets.
3) Possible breakup value adds other "possible" assets to all of the above.

[Also included in 1(a), 1(c), and 4] **[PREVITS, p. 19]**

[Context] The AIMR position paper provides the following summary of the section (pages 6-11) entitled "Financial Analysis and Financial Reporting

This section provides primarily descriptive information. It discusses the interrelationship between the efficient market hypothesis (EMH) and other theories of financial economics and the role of financial analysis in making markets efficient. It presents a description of the analytic process to the extent that generalizations can be made in that area. It lists and describes the vast variety of information sources used by analysts, of which financial reports are an indispensable part of the whole. It then describes in more detail each of the financial reports analysts rely on in their work. [Also included in 1(a) and 1(c)] **[AIMR/FAPC92, p. vi]**

One of the most important points made in this section is defining the distinction between financial analysis and financial reporting. We believe that financial reporting should be concerned with presenting the economic history of specific economic entities and that it is best done when managements also are willing to disclose and discuss their strategies, proposed tactics and plans, and their expected outcomes. Forecasts of the future and similar material enhances financial report usefulness, but must be separated from and not confused with the financial statements themselves. The function of analysis is to allow those who participate in the financial markets to form their own rational expectations about future economic events, in particular the amounts, timing and uncertainty of an enterprise's future cash flows. Through this process, analysts form opinions about the absolute and relative value of individual companies, make investment decisions or cause them to be made, and thereby contribute to the economically efficient allocation of capital and clearing of the capital markets. [Also included in 1(a) and 1(c)] **[AIMR/FAPC92, p. vi]**

[Context] Those two paragraphs introduce the following excerpts and relate them to excerpts from the same section included in 1(a)-Investors' and creditors' objectives and approaches and 1(c)-Investors' and creditors use of information to achieve their objectives.

<u>Sources of Information</u>
Economic and Industry Reports
A common starting point in the analytic process is to assess the state of the economy and the various industries within it. Information to do so comes from a variety of sources. Economic reports and prognoses are available both from the government and from private sources. Many financial firms have their own in-house economic experts who provide continual updating to the rest of the firm, its customers and sometimes to outsiders. **[AIMR/FAPC92, p. 5]**

Industry-specific data come from the government, trade associations, the business press and a variety of other sources. Often it is obtained indirectly from companies within the industry. It usually requires analysts who follow a particular industry to participate in meetings, conventions, trade shows, and other industry-wide events. They also must keep up to date on technological advances and other industry changes. **[AIMR/FAPC92, p. 5]**

Company-Specific Information
Financial reports are the beginning and ending points in obtaining information about individual companies. As a starter they provide an overview of the company's business, its status and its performance for a series of years. It is difficult to think of a better primer than the combination of an annual report to shareholders, complete with the Chairman's letter to shareholders, financial statements, management's discussion and analysis of them, as well as other descriptive material; plus a Form 10-K with all of its detailed description of business, facilities, risks, contingencies, and other mandated disclosures. At the end of the information gathering process, financial reports are used to corroborate the vast array of company specific data assembled from the various sources described next. [Footnote reference omitted.] **[AIMR/FAPC92, p. 6]**

Many of the data used by analysts come directly from companies themselves. Sources include press releases and other announcements, including preliminary earnings numbers. Information is received orally from company executives, sometimes in analysts' meetings, other times by telephone or during analysts' visits to the company's premises. Plant visits and field trips allow analysts to compare the company's written and oral representations to the reality of its operating conditions and atmosphere. Many companies entertain analysts, usually in groups, in order to present their stories in the most favorable circumstances. One of the tasks of an analyst is to sort through all of the favorable information to discover and weigh the facts that are most germane to assessing a company's future prospects. **[AIMR/FAPC92, p. 6]**

The business press provides substantial amounts of information about individual companies, much of which is now captured in databases. In some instances, a clipping service may be used to gather data on a particular company. Almost every major industry and many

subdivisions of them are covered by specialized publications. These are must reading for industry specialist analysts who use them to gather intelligence, not only about the state of the industry, but also about the performance and status of the individual firms it comprises. **[AIMR/FAPC92, p. 6]**

Finally, a good amount of information about individual companies may be obtained through government documents and filings. One example is the call reports filed with the United States Comptroller of the Currency by banks. Another is the filings by insurance companies, public utilities, and other regulated companies with state and federal commissions. These are indispensable documents to analysts following those industries. Individual company pension plan filings with the United States Department of Labor are another example. Government Accounting Office studies and testimony before the Congress and regulatory agencies are other important sources of information. Under some circumstances, shareholders holding as little as one percent of a company's shares may obtain copies of its Federal income tax returns. Since enactment of the Freedom of Information Act more and more specific company data have been available to the public. In a number of cases however, the incremental value of the available data may be less than the cost of the effort necessary to obtain it. **[AIMR/FAPC92, p. 6]**

Financial Reports Used By Analysts

The use of financial reports will differ from analyst to analyst, depending on the purpose of the analysis and the analyst's personal style. . . . The depth of an analyst's study of financial reports is in inverse proportion to the number of companies he or she follows. To some extent, that depth also is a function of the analyst's interest in and understanding of financial accounting and reporting standards and disclosures. **[AIMR/FAPC92, p. 7]**

At the top of every analyst's list is the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary or supplementary to it. That is one of the reasons AIMR and its predecessor, the Financial Analysts' Federation, is and has been totally opposed to companies issuing what is called a "summary annual report." Financial analysts expect the annual report to shareholders to contain a complete set of financial statements. Even though, for such companies, a full set of audited financial statements must be included in the proxy statement, it may not be received routinely by a non-shareholder analyst. Furthermore, the financial statements contained in a "summary annual report" are incomplete and may well mislead less sophisticated investors who are unaware of that fact. **[AIMR/FAPC92, p. 7]**

The annual report on Form 10-K is automatically regarded by most analysts as an essential complement to the annual report to shareholders. It contains several important types of supplementary financial schedules. In addition, it provides detailed descriptions of the business and contains a record, available nowhere else, of other available documents incorporated by reference. **[AIMR/FAPC92, p. 7]**

Other than the financial statements themselves, perhaps the most useful single part of the annual report is the management discussion and analysis (MD&A) mandated for inclusion by the SEC. Its information content varies from company to company, but it provides for all companies insights that are not apparent from the financial statements alone. It discloses items

that tend to make year-to-year income numbers noncomparable. It provides narratives to accompany the factual disclosures in financial statement notes. It has been less effective in giving management the opportunity to discuss the company's plans and prospects, information of utmost relevance to analysts. Although it is less than perfect, we have detected progressive improvements in the MD&A over time, many of which can be attributed to the efforts of the SEC to enhance its quality. **[AIMR/FAPC92, p. 7]**

Analysts are constantly updating their projections and need timely financial reports to assess how well they and the companies they follow are doing. Quarterly reports are vital to the analytic process, particularly the detailed reports provided on SEC Form 10-Q, which include a mandated MD&A section. Many analysts also find helpful the management representations contained in the briefer quarterly reports to shareholders. For reasons set forth in detail later in this report, we oppose the movement in certain quarters to eliminate or otherwise attenuate interim financial reporting. **[AIMR/FAPC92, p. 7-8]**

Many companies publish and distribute on request additional financial and statistical information beyond that contained in their annual reports. These "fact books" or similar documents are used extensively by analysts. The proxy statement provides information about compensation of the company's senior management and the shareholdings of directors and officers. Forms 8-K give information on major current developments affecting the company. There also are a variety of special financial reports, peculiar to particular industries and/or companies that analysts find useful in their work. **[AIMR/FAPC92, p. 8]**

Use of Databases and Quantitative Techniques

More and more financial data are to be found in databases, some of which are publicly available while others are proprietary. Of the publicly accessible databases, one extreme is represented by COMPUSTAT, which contains financial statistics on over 10,000 U.S. companies, organized by industry code and arranged in a standardized financial statement format. At the other extreme, is NAARS (National Automated Accounting Retrieval System). It contains the actual text of the financial reports of over 5,000 companies. Both of those databases include several years of data. In between are an unlimited variety of specialized databases offered by all sorts of vendors, including, among others, the FASB itself. [Also included in 16(a)] **[AIMR/FAPC92, p. 15]**

Use of databases varies from analyst to analyst. Some analysts ignore them and continue to obtain all of their company and industry information from more traditional sources. Others may use them to screen a large universe of companies to weed out those that do not meet certain criteria. The screening process often involves the use of financial ratios and the program employed is generally concerned more with processing large quantities of data rather than performing sophisticated computations. Another group of analysts will use highly complex quantitative techniques to make portfolio selections and as a guide to other market transactions. [Also included in 16(a)] **[AIMR/FAPC92, p. 15]**

[Context] Discussions of seven "Broad Topics of Current Importance to Analysts" constitute about half of the AIMR position paper and are related to each other and to the rest of the paper. Not only does the rest of the paper provide a basis for discussing the seven topics but also uses aspects of the seven topics as examples in discussing the relationship between financial analysis and financial reporting, the changing world and its implications for analysis, and the qualitative characteristics of financial statements.

The following excerpt begins the section entitled "Broad Topics of Current Importance to Analysts," introducing the seven topics as a group and listing them individually. Numbers and names in the brackets identify the category(ies) in the Special Committee's database containing the bulk of the text quoted from each of the seven discussions.

> In this section we address several financial reporting matters that are of current and continuing importance to investment managers and analysts. Some of the subjects considered herein embody difficult questions for both financial reporting and financial analysis. On some of those questions financial analysts hold strong and unified views. On others, opinion among analysts is divided, although the views may be no less strongly held. The topics for discussion are: **[AIMR/FAPC92, p. 23]**
>
> - "Mark-to-market" accounting. [4-Value information]
> - Accounting for intangible assets, both purchased and self-developed. [7(a)-Goodwill; 7(b)-Other intangible assets; 8(c)-Leases and other "executory" contracts]
> - Frequency of reporting, with special reference to quarterly reports. [11(a)-Frequency of interim reporting; 11(c)-Content of financial statements and related disclosures]
> - Disaggregated financial information. [3(a)-Compliance with and criticisms of Statement 14; 3(b)-Basis of disaggregation; 3(c)-Types of disaggregated information disclosed]
> - Form and content of both income and cash flow statements. [5(a)-Income statement, including core earnings and comprehensive income; 5(c)-Cash flow statement]
> - The transition from old to new accounting standards. [2(c)-Comparability . . .; 16(a)-Databases]
> - The standard-setting process and its critics. [18(a)-International harmonization of standards; 18(d)-Investor and creditor involvement in setting accounting standards; 18(e)-FASB]

[AIMR/FAPC92, p. 23]

[Context] The AIMR report's introduction to the section entitled "Summary of Important Positions and Guide to Future Actions" begins and ends as follows:

> Much of this report relates to the present state of the art and implications for future developments in financial reporting. Righfully, so do most of the positions stated in this section . . . [T]hey all build on positions taken by AIMR in the past . . . [Also included in 1(d), 3(d), 4, 5(a), 8(c), 11(a), 12, 18(a), 18(c), and 18(d)] **[AIMR/FAPC92, p. 59]**
>
> We expect the positions set forth below to build on the precedents of the past. That does not prevent them from breaking new ground, but they do not introduce significant inconsistencies with previous AIMR positions. To the extent that they do establish new stances those are largely the result of the changing world that we describe earlier in this report. [Also included in 1(d), 3(d), 4, 5(a), 8(c), 11(a), 12, 18(a), 18(c), and 18(d)] **[AIMR/FAPC92, p. 60]**

Those two paragraphs introduce the following summary of a position taken by the Committee.

> Set Financial Information in Its Business Context
> In order for financial analysts to make sound judgements and draw rational conclusions, they must judge the performance of individual business enterprises. Performance appraisal is largely a matter of evaluating how well the management of an enterprise has achieved its goals. Businesses are for the most part operated according to plans, either explicit or implicit. Investment professionals aspire to allocate capital to those plans that seem most likely to succeed. In order to do so, they need information of two types. [Also included in 1(d)] **[AIMR/FAPC92, p. 61]**
>
> First, management should explicitly reveal its strategies, plans and expectations. Much of this must come in the form of narrative descriptive material. Dollar amounts of budgeted and other anticipated amounts are useful for expressing plans in more concrete terms. Goals for growth rates in revenues, market share and the like should be stated. Analysts need anticipated amounts of key ratios, such as the return on total invested capital or on equity, the ratio of debt to equity and so forth. Factors that are expected to affect those ratios should be divulged, eg. major financing or capital spending plans. [Also included in 1(d) and 12] **[AIMR/FAPC92, p. 61]**
>
> Second, results need to be reported in a manner that is consistent with the organization and management of the firm. Different entities, even within the same industry, may organize their operations in totally dissimilar ways. Financial analysts need information in formats that allow them to compare those firms both against each other and against their own business plans. The task of devising accounting and disclosure standards to mandate dissemination of information in the fashion we advocate is perhaps not totally surmountable. Thus we look to business enterprises themselves to act with goodwill and in their own interests to explain themselves and

their operations in "user friendly" ways even when it is not strictly required. [Also included in 1(d)] **[AIMR/FAPC92, p. 61]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When asked about their objectives and approaches to evaluating equity securities, some investors referred to the types of information they used to achieve their objectives.

Participant I-1
Under the fundamental approach, you are overlaying more judgment to the numbers. So you are concerned with the markets, the customers, the critical variables, all the things you don't generally get from financial reporting. I find historical financial statements to be virtually worthless as a fundamental analyst. I could virtually not have the front part of the financials if you put notes disclosing significant litigation, asbestos liability, unfunded pensions plans: that is probably the most I get out of the historical statements. You have to start some place, but I'm not sure that gets you too far. [Also included in 1(a)] **[TI 10/16, p. 4-5]**

Participant I-4
I think historical numbers are necessary but not sufficient to do fundamental work. The people here from the investment field are probably all fundamentalists. We do special situation work, we are trying to determine what is the real corporate value of companies which we are analyzing or buying. We attempt to analyse cash flows and/or redundant assets, and then putting some kind of capitalization rate on that growth. So it is important for us to look at what we think is real generation of cash flows; for that, you need historical data but also a lot of judgment work. Once we determine what value is, we attempt to find whether the company agrees with us in realizing value. A lot of the value comes out because corporate activity occurs, not because the stock market goes up or down, but because someone internally realizes that values in a real world are substantially higher over time than what the price is in the marketplace. [Also included in 1(a) and 1(c)] **[TI 10/16, p. 5]**

Participant I-9
We have about $20 billion under management and a research department of about 7 or 8 people. It used to be that an institution of that size would have about 30 analysts; those days are over. Which means that the job of the financial reporting community has become more important; the analysts cannot know the industries in the same depth they did before. We never make an investment unless we have audited financial statements of the company and we don't make an investment unless we meet the management of the company. Our approach is fundamental; the valuation starts with the financial statements and then our projections going forward, based on what management tells me and what we see in the trends of the company. The other aspects are psychology and momentum; the accounting profession cannot help us with that. Sometimes, we rely heavily on the information provided in financial statements, at other times that's not what is going to lead us to make the right investment decision. [Also included in 1(a) and 1(c)] **[TI 10/16, p. 5-6]**

Participant I-2
Your client base in accounting is dealing with a dynamic system, not only with changes in the economy, but also the secular changes. For example, the accounting opinion on inflation years ago; it turns out it was so difficult that it ended up not being terribly useful. For the last five or six years, we're seeing companies doing things we never thought they could: massive layoffs, wage givebacks, etc. As a fundamental analyst, you need the ability to get inside the company and understand what makes it tick. So you want to understand sources of cash flow and how the business works (and that on a quarterly basis). What if scenarios are very important to us; we need the detailed information to do those "what if" exercises because it is a very important element of our job. [Also included in 1(a)] **[TI 10/16, p. 6-7]**

Participant I-8
Earnings is the starting point. But there is another layer which is the external setting (how the company is perceived). [Also included in 1(a)] **[TI 10/16, p. 8]**

Participant I-6
Earnings are the common denominator, much more than cash flow. But I don't want to dismiss the importance of cash flow. You can't forecast cash flow without forecasting earnings. For an analyst, some industries' cash flow is much more critical than earnings. Other industries' cash flow is important but that's not the common denominator. In the marketplace, most people talk about P/E ratio, not cash flow multiples. And in many of the discussions with portfolio managers who focused on cash flow, not more than half a dozen agree on the definition of cash flow. Until we get a standardized definition of cash flow, we are deceiving ourselves in some respect to say that we can look at a cash flow statement and come up with a meaningful number. Cash flow is an important number in fundamental analysis, but it comes after the earnings. [Also included in 1(a)] **[TI 10/16, p. 8]**

Participant I-12
The purpose of external reporting is to give some basis to look at the value of a company today and a basis to look in the change and potential change in that value. [Also included in 1(a)] **[TI 10/16, p. 16]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. Investors were asked about the types of information they use to achieve their objectives and the relative importance of that information. Page 12 of the meeting materials listed the following general categories of business information regarding the company and its environment that the Committee believes investors use in following the fundamental approach:

General economy:

- Social, demographic, technological, political, and regulatory trends

- Historical and projected macroeconomic data

Each industry in which the company participates or plans to participate:

- Definition and boundaries of the industry
- Industry structure (bargaining power of customers and suppliers, threat of substitute products and new competitors, and intensity of competition) and outlook
- Historical and projected aggregate financial and operating data

Company:

- Company mission
- The company's strategy and strategic alignment
- The company's ability to innovate, adapt to change, and continuously improve
- Competitive advantages managed at the company level
- Opportunities and risks managed at the company level
- Historical and projected financial and operating data related to the company

Each industry segment within the company

- Description of the segment's business
- Segment mission
- The segment's strategy and strategic alignment
- The segment's position within the industry
- The segment's ability to innovate, adapt to change, and continuously improve
- Competitive advantages and disadvantages managed at the segment level
- Opportunities and risks managed at the segment level
- Historical and projected financial and operating data related to the segment.

Investors were asked two questions in reference to the above list:

- Do you currently use business information in each of the categories listed?
- And conversely, do you use business information in categories not listed?

Participant I-7

I use much of the information listed here. What I don't see is programs aimed at giving us information from a marketing, merchandising, distribution point of view. [Also included in 13] **[TI 10/16, p. 17]**

Participant I-1
Our approach is starting with the basic 12-page due diligence list, recognizing that you only get half a page of that out of conventional external reporting. The rest of it is digging the information around. A good part of what is on your list has to be obtained from non-external reporting sources; for example, talking to customers and suppliers. You may not get some information from the company you're talking to, so you have to go around it. In other cases, you may have tremendous concentration in the customer base and that may not be evident from the external reporting (although the footnotes may give some concentration disclosures but not as much as we would like). Probably 80% of the information you need has to be obtained either away from the company or have the company sit down and have a candid conversation with you. There is disparity in what company will tell people. We tend to focus on midcap-type of companies which generally enjoy the opportunity to sit down and talk a lot, compared to the Fortune 1000 where it's more institutionalized. Even within those companies, they migth tell person A something different than what they tell person B. So there is a tremendous amount of variability in the other types of information that is disseminated. [Also included in 1(a)] **[TI 10/16, p. 17-18]**

Participant I-11
One of the ways we measure the course of business activity is through financial statements. But the statements are the measurement and not the activity itself. The most important things to evaluate a company and the prospect for its stock are the company's strategic plan and the tactics it has for putting this plan into action. I don't get any of that from financial statements because that's not what they are for. **[TI 10/16, p. 18]**

For example, when I look at companies in the wholesale distribution area, I'm interested in their vision in how their business is evolving and how they are positioning themselves to deal with the changing environment. Then I go back and say what this implies in terms of earnings, sales, expense ratios, cash flows, and other financial issues. But the most important things aren't in the financial statements at all. [Also included in 13] **[TI 10/16, p. 18]**

Participant I-6
Thinking about the purpose of financial reporting reminds me of an annual report of a mining company a few years ago where two-thirds of the chairman's letter in the report talked about gold. Yet the financial statements did not disclose any financial data on the gold operations. One of the things not clear to me is whether the financial statements are just the audited portion or the report as a whole? [Also included in 13] **[TI 10/16, p. 18]**

We use most of the information listed here. **[TI 10/16, p. 18]**

Committee/Staff/Observer

1(b). Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information--Page 39

One of the things we would like to know is: what information that is not in financial reporting that you are going to other places for would you like to see in financial reporting? **[TI 10/16, p. 19]**

Participant I-6
A lot of production data or industry-type data that help rank the company within their peer group. You can find a lot of that in reports by other mining companies elsewhere around the world, but not in the U.S. [Also included in 13] **[TI 10/16, p. 20]**

Participant I-5
More segment breakout is a critical thing (consistently presented). Also, as for information that you can get externally that could be provided in the financial statements, if you can get the aggregate statistics for an industry from the government or some statistical service or some trade organization, I think you're better served doing that than relying on the company's annual report, because you are going to some kind of an objective benchmark outside the company. [Also included in 3(b) and 13] **[TI 10/16, p. 20]**

Participant I-7
I head a subcomittee that looks at investor information in the electrical equipment industry. The disseminated information is very uneven. A major effort was made over the last 5 years to get some consistency in FAS 14 reporting; probably 75% of my companies do not report sufficiently on a FAS 14 basis. The other point that is absolutely critical is giving out meaningful industry information. In the more mature industries, you can get government statistics, but in a lot of cases, those statistics are 12 to 24 months old in time. If I can get some consistency in reporting in the annual report on industry information, that is, total statistics, growth by segments, and market share, the truthfulness of that information can be checked by playing one company off against another. That information is very critical. [Also included in 3(a) and 13] **[TI 10/16, p. 20-21]**

We don't get good FAS 14 disclosure in the annual report and we get less from most of our companies in the quarterly reports. FAS 14 is just an abomination at least in my industry from a quarterly point of view. I also heard the argument about the expense of creating this information. There isn't a reasonable size company that doesn't have internal reporting and the people inside the company get a report card, if not monthly certainly quarterly, and that's the kind of information that is readily available that I would like to see. One of the things that should be discussed somewhere is: what the information that we as outside investors should not be permitted to get from a competitive point of view? They all know internally what their competitors are doing and yet they don't want to provide certain information to us for competitive reasons. It's vital that the accounting profession decide what kinds of information are competitively harmful and others that aren't. [Also included in 2(d), 3(a), 3(b), 3(d), and 11(c)]**[TI 10/16, p. 21]**

Participant I-6
I totally agree with [participant I-7]. Sometimes you go at conferences and you hear companies bragging about their position in the industry and that's the kind of information that they didn't want to give to you before. **[TI 10/16, p. 21]**

Coming back to cash flow, I think it's important but I don't think you can get there without earnings. If we're going to have true segment disclosures, earnings are nice but with a diversified company that is in coal mining, gold mining, natural gas and manufacturing, how

about having cash flows by segments too? Cash flow is an important piece of the equation, but if you don't have it by segment, you're deceiving yourself if you think you're forecasting. [Also included in 3(c)] **[TI 10/16, p. 22]**

Participant I-11
I join the chorus on segment accounting. We could do with much more consistent and detailed segment accounting on a quarterly basis. At least two diversified companies that I know establish the segments they report in a manner totally separate from the method in which they run their business and it's clear they're just trying to obfuscate things. I can't find any justification for that. [Also included in 3(a), 3(c), and 3(d)] **[TI 10/16, p. 22]**

Another point is the MD&A which usually reads something like this: sales were up because we sold more products at higher prices, cost of goods was up because we paid more for raw materials, and gross profit was down because cost of goods went up more than sales. That's about what you get in 90% of MD&A; that is a farce. Either require management to have meaningful discussion of their operations or get rid of it. [Also included in 2(d) and 13] **[TI 10/16, p. 22]**

Participant I-9
I don't think it's worth the costs for the companies I follow to have segment reporting on a quarterly basis. What I would ask is that it be consistent from year to year. With respect to pharmaceutical, for example, if you switch a drug from the ethical sector to the over-the-counter sector, make some sort of adjustments in the figures of the prior years so we can look at the trends on that. I go back to the point about what the auditor should look at for a particular industry. With respect to pharmaceutical, the companies are now showing price increasing data; it would be nice to have an auditor to say whether that data is reasonable. Research is also a big item; why not segment out what is basic research from research on drugs and give the FDA categories (phase 1, phase 2, and phase 3 breakdowns)? The other problem in the area is that companies are international; for example, [name deleted] has 40% of its business in the U.S. and is headquartered in London. You convert the U.S. earnings to British accounting and then reconvert it back to ADRs and you can get two reports that have to be reconciled for a company that is half in the U.S. and half abroad. And you will have more problems with the Swiss companies. The other problem is marking to market on currencies. We don't understand the accounting standards. Those areas call for particular expertise where accountants could be very helpful. [Also included in 3(c), 3(d), and 17(b)] **[TI 10/16, p. 23-24]**

Participant I-3
I agree that segment reporting is not as good as it should be and should be improved. But a lot of companies will resist that for a variety of reasons, and in some cases it is because they themselves don't know what is critical to their own businesses. The analyst's job is to find out what is critical. Disclosure will always be somewhat disatisfying because it will never be full. When a company is witholding information from me, there are plenty of other entities that I can focus on; I don't need to have a strong opinion on all of them. I just need to have an accurate opinion about a few of them. [Also included in 3(a)] **[TI 10/16, p. 24]**

Participant I-2
This is a laundry list of what I would like to see:

- Constant mix pricing (the aluminum industry's currencies are all over the map, for example)
- Breakdown of significant debt (10% or more) based on when they can be called and on which terms. What we try to do is understand how the dynamics of business and interest rates affect the company.
- A record of cost for raw materials
- A product line breakdown. Aluminum companies will give some sort of catch-all disclosure for transportation (autos, trucks, and aerospace). There's a big difference between a small car and an airplane; one product sells for $1.20 a pound, the other $5 to $6. The steel industry provides a detailed breakdown, but not the aluminum industry. We're the owners of the companies essentially and we are not being informed as to what is happening. **[TI 10/16, p. 24]**

Participant I-7
Let me list the sources other than external reports that I used to get segment information:

- Discussions with management
- Discussions with competitors
- Government statistics
- Industry trade groups
- Trade show presentations. **[TI 10/16, p. 24-25]**

I would like to see more of the information reported in annual reports but it depends on the industry. Many of the trade groups that have information from the existing companies do not give us that information. Government statistics for the most part are either ancient or not usable. I'm looking for a level playing field, so I would like to see more information in the annual report. **[TI 10/16, p. 25]**

Participant I-10
A question to the group: do you believe that your forecasts are better for companies that provide you with unlimited information? **[TI 10/16, p. 25]**

Participant I-7
Yes. **[TI 10/16, p. 25]**

Participant I-2
I find the securities gets a higher value but it's harder to make money in those securities. **[TI 10/16, p. 25]**

Participant I-9
I would say no. **[TI 10/16, p. 25]**

Participant I-6

You can take 2 companies in the same industry, for example [names deleted]. [One company] inundates you with paper but you have a lot more understanding and information out of [another company] every day of the week. **[TI 10/16, p. 25]**

Participant I-8
Part of this will be the result of the pressure that the AICPA can bring on management to make more disclosures. The most common argument for limiting segment disclosures is the fear of competitive disadvantage. A company that I have been following for a long time in Long Island and that has a sensational record of growth have been providing for a long time very detailed market share information, including what they thought their competitors' shares are, and it hasn't been a disadvantage to them. I would argue that additional disclosure doesn't hurt. [Also included in 3(a) and 13] **[TI 10/16, p. 25-26]**

Committee/Staff/Observer
We were discussing nonfinancial business information. Now, we are going to talk about things that perhaps you don't really need. What information required by external reporting do you not find useful? The problem that we face as a committee is that we hear requests for more information and, at the same time, complaints about things being much too complex. It is easy to ask for more and it's always difficult to give up something. Is there anything required that you really don't find useful or that can be abbreviated or cut down in some manner? **[TI 10/16, p. 26]**

Participant I-7
I tell new people that I work with that I want to know everything. I will make the decision of what is useful. What may be useful in a particular quarter or year may not be useful in a subsequent year. It does not necessarily have to be in the annual report, but I want it somewhere where I can get my hands on it. **[TI 10/16, p. 26]**

Participant I-12
We analysts are information junkies. So it's really hard to give anything up. I know how I analyse the financial reports: I start at the very back and I work through the footnotes, I totally ignore the formal income statement, balance sheet, and cash flow statement and I go to the front and read the chairman's letter. The formal statements for about 90% of the companies I cover are virtually meaningless except in a bankruptcy situation. At that juncture, they begin to take on some meaning. I cover financial companies. Average balance sheets are the most important thing I can look at. And the footnotes are important. **[TI 10/16, p. 26]**

Participant I-7
When you're PC related and model related, which is mostly the case from a sell-side point of view, you are keenly interested in the formal statements. **[TI 10/16, p. 26]**

Participant I-6
I think the formal statements are very important. I include them in my model and I see the % changes. But more importantly, then I read the footnotes and the front of the annual report and I try to reconcile what they say about the company to what the financial statements

actually say. Nine out of 10 times, the MD&A doesn't even address what changed in the financial statements. [Also included in 2(d) and 13] **[TI 10/16, p. 27]**

Financial statements are very important but they are only a place to start and do trend lines. The thing I would like to see is a reconciliation between what is said in the chairman's letter one year and what is said the next year. **[TI 10/16, p. 27]**

Participant I-11
80% to 90% of the time, the detailed information particularly in the footnotes is not useful, except we never know which 80% or 90% and I think that's the point. **[TI 10/16, p. 27]**

Participant I-5
I agree with [participant I-11] particularly when you talk about something like the statement of shareholders' equity. I don't think anyone here has talked about ever using that. Yet, in very rare cases, you can find it to be critical. A company like [name deleted] would be one case where you should look at that. If you don't have it, you'll never know, so you need everything that's in there. **[TI 10/16, p. 27]**

Committee/Staff/Observer
How many read the footnotes word for word? **[TI 10/16, p. 27]**

Participant I-7
I'll admit that when it comes to comments on common shares outstanding, I'll just glance through for anything unusual, I will not read it. **[TI 10/16, p. 28]**

Participant I-3
For certain companies or for certain industry segments, from time to time certain issues become very important. When that is the case, I want to focus in on as much information as I can get on those issues and footnotes are a help but sometimes don't provide enough. But most of the times, most of the footnotes are not that important but I want them there because it is a source of information. **[TI 10/16, p. 28]**

Participant I-9
I read footnotes by exception: I scan them. If it's a retail company, you look at the LIFO reserve. If it's a technology company, you look at the period of time over which they amortize the software development costs. The tax table is one of the things that is particulary well done; it doesn't take a lot of room, it's very clear, you can glance at it and go on. Most of the problems seem to come up with timing differences, where there is a difference between the economic life and the accounting life, and you're trying to sort out what it is and it varies from industry to industry. I have a rule that if footnotes get over 5 pages, I lower the valuation at which I'm willing to recommend the stock. If they get over 10 pages, I'm not going to touch it! **[TI 10/16, p. 28]**

Participant I-12
I would like to defend the common shares and equity accounts. There have been many times over the last few years with the financial industry going down the tube that I found that those

statements have been quite useful for determining whether the company was viable or doomed. There has been a lot of change in accounting and unless you read the first footnote (accounting policies), you don't realize what is going on. In some cases, there are significant accounting differences from year to year in the statements that you use as a basis for your model. The tax footnote is terrific; the best addition in recent years is the footnote on off-balance-sheet financing. Almost every single footnote is useful. **[TI 10/16, p. 28]**

Participant I-9
What about something like [name deleted] where half of the earnings come from transactions that are never reported in the annual report or footnotes in any place, and yet it is obviously a quality company. Do you find that very helpful to you looking at a company like that? **[TI 10/16, p. 29]**

Participant I-12
We're starting to see some revenue data and some of the footnote information can be used to interpolate or extrapolate. It's a very difficult situation and that's a company that needs to show segment reporting; [names deleted], where you have banking businesses and securities trading businesses and transaction processing businesses. An analyst can make a lot of money going through those things because nobody knows what it is, so whatever you say, they'll assume you know what you're talking about. I do think there are useful tidbits in the footnotes. [Also included in 3(e)] **[TI 10/16, p. 29]**

Committee/Staff/Observer
One last probing and I have a personal bias on this one. What about the detailed information in the pension footnote? Do you read that pension footnote and understand all of it and need absolutely every last bit of it? **[TI 10/16, p. 29]**

Participant I-9
I was investment manager at [a company's] pension fund for 12 years. The numbers were worked backwards to give a total that looks something reasonable but wouldn't cause problems with the next union negotiations. That the rate of return was not something that the employees would feel we couldn't make, and it was to show that we were about 85% funded because they wouldn't have any worry that we could pay the pensions. If we showed that we were overfunded, it was an open invitation to take it away from us. It was a case of "what do you have in mind"? The company would have been insolvent if they had taken completed transactions for the number of people that they were going to lay off in the coming years at $50,000 a head. Now, you're seeing companies like [name deleted] claiming they can make 12% investment return on their pension fund. So it's an absolute disgrace. [Also included in 2(d)] **[TI 10/16, p. 29]**

Participant I-7
The pension footnote is only a starting point for me. None of my companies does a worthwhile enough job so that I can just read the footnote and be comfortable. It's just a starting point for me to go back and have discussions with my company on that particular matter. **[TI 10/16, p. 30]**

Participant I-2
Right now, [one company] is taking a pension credit, they're overfunded; they're taking a credit of something like $280 million. [Another company] has a pension expense of about $200 million. So you have a net swing of almost 1/2 billion dollars caused by the pension situation, which is about $50 a ton. You have to pull out [one company's] credit because it's an accounting phenomenon, it has nothing to do with cash. It's very critical. In a lot of cases, the company is really working for retired employees and there is no value to shareholders. I think the note has to be improved dramatically. It should show the number of active and retired employees, the pension costs for both categories, and perhaps disclosures based on a standardized % return (for example 9%). **[TI 10/16, p. 30]**

Participant I-12
The pension footnote is one of the few instances where an accounting change has generated a change about how management economically thinks about the business. It generated this conversion we have seen from defined benefit to defined contribution plans, because companies don't want to mess with the disclosures. **[TI 10/16, p. 30]**

Committee/Staff/Observer
What adjustments do you routinely make to the financial information in external reporting to make it more useful to your purposes? We are interested in the types of adjustments that you make because that knowledge will help us (1) identify the information that you find particularly important, (2) better understand your objectives and approach, and (3) identify candidates to suggest to the FASB to improve financial reporting. In the premeeting materials, we have listed 7 items that we hear are the types of adjustments you make most often to financial information[:

- Adjusting reported income for the effects of nonrecurring items
- Adjusting repored income for non-cash charges, such as amortization or depreciation, and capital expenditures
- Adjusting the financial statements to capitalize certain operating leases
- Adjusting the financial statements to recognize the unfunded or overfunded pension or postretirement benefit obligation?
- Adjusting the financial statements to reflect other off-balance-sheet items
- Adjusting equity for goodwill or deferred taxes
- Adjusting the financial statements to reflect a different accounting principle so as to make the information more comparable with that of the company's competitors, or more consistent with the company's information presented for earlier periods.] **[TI 10/16, p. 31]**

What are your reasons for your adjustments? **[TI 10/16, p. 31]**

Participant I-1
The first one on the list (taking out nonrecurring items) is the most common adjustment but the question we have with nonrecurring is whether it really is nonrecurring? If they're taking a $200 million charge every year in the third quarter, is it nonrecurring? You also get into the issue of comparability of statements from year to year because if there is a regular pattern of charge-offs in a given company, generally it will have an industry effect. So you'll have a

number of companies in an industry having charge-offs in different quarters and different years. So comparing companies' results with their competitors becomes extremely difficult. Another issue is the components of the nonrecurring charges, how they were determined. You always think a company has taken a very large reserve because they don't want to provide again. [Also included in 2(c)] **[TI 10/16, p. 31]**

Being a cash flow person, we make adjustment for the noncash charges. Another thing we adjust for is irregular tax rates. I am surprised how a company's tax rate can vary so much from year to year; you'll have a company with 25% tax rate in one year and 38% the following year. So we try to normalize the tax rate. **[TI 10/16, p. 31]**

Another big issue not easily quantified is the environmental side. The lack of information about environmental considerations is an impediment to business today; you can't get a bank loan on a real estate property without providing information about the current and previous use of the property. The environmental issue is treated the same way that OPEB was handled five years ago; we got a problem and don't know what it is but maybe something can be done to quantify that better (or even a range in the footnotes would be helpful). [Also included in 13] **[TI 10/16, p. 31-32]**

Participant I-12
I restructure the entire income statement in the following way: net interest income + fees (commission) + capital gains line (divided into ongoing business and discretionary items) + trading. That's the only way I can get closer to the cash flows that are part of the ongoing economic value of the business versus discretionary; in other words, management versus market-driven. **[TI 10/16, p. 32]**

Participant I-8
My guess is that everybody here will answer that they make adjustments. The specific adjustments I make might be different from somebody else because they will be particular to the nature of the business that the company is in. **[TI 10/16, p. 32]**

Participant I-11
I think all of us from time to time will make all or most of these adjustments. The issue of comparability is one that arises frequently and is perhaps the most common reason I make adjustments to financial statements. But I am against a real strong stand by the accounting profession on doing away with choices. I'm thinking specifically of the decision made in the interest of comparability that nonfinancial companies had to consolidate their finance subsidiaries. Now when I look at a company, I don't know what I'm looking at. I think that was a terrible decision because it has reduced the amount of information available to me. So, I think we are all for comparability but I'm not sure it's universally good. [Also included in 2(c) and 8(a)] **[TI 10/16, p. 33]**

Committee/Staff/Observer
What about goodwill? [Also included in 7(a)] **[TI 10/16, p. 33]**

Participant I-5
I will automatically write goodwill off the balance sheet and add it back on the income statement. There is no economic value to it on the balance sheet and there is no economic cost in the income statement. Further, whenever you have a cash flow statement, I will separate depreciation of plant and equipment from goodwill amortization. [Also included in 7(a)] **[TI 10/16, p. 34]**

Participant I-1
What about amortization of things other than goodwill (software, for example)? [Also included in 7(b)] **[TI 10/16, p. 34]**

Participant I-5
Software of course depreciates. Amortization of film inventories counts, it's critical. [Also included in 7(b)] **[TI 10/16, p. 34]**

Committee/Staff/Observer
.So you differentiate goodwill from other intangibles. [Also included in 7(a) and 7(b)] **[TI 10/16, p. 34]**

Participant I-5
Goodwill is an easy one. Other intangibles, you have to think about. Goodwill is virtually automatic. [Also included in 7(a) and 7(b)] **[TI 10/16, p. 34]**

Committee/Staff/Observer
A quick poll: how many agree with [participant I-5] that goodwill as a charge on the income statement is taken out and add back? How many leave it as a charge? What about on the balance sheet: how many take goodwill out and say whatever is reported there isn't really an asset? [Also included in 7(a)] **[TI 10/16, p. 34]**

Participant I-8
Let me ask you why would you care if we leave it in or take it out? [Also included in 7(a)] **[TI 10/16, p. 35]**

Committee/Staff/Observer
Maybe we want to recommend a change in accounting for goodwill because it has been debated for 50 years as to whether it should be charged immediately to the equity section (not even set up as an asset). The argument being why that piece of goodwill, purchased goodwill, is capitalized as an asset; doesn't a company that has spent nothing but built up a trademark, a logo, or name have a value? So there is a dichotomy in what is really goodwill? [Also included in 7(a)] **[TI 10/16, p. 35]**

Participant I-8
When it doesn't affect cash, it doesn't matter. So whether you have it on the balance sheet or not is not relevant. Whereas if it's affecting reported earnings because it's a noncash depreciation charge, you have to make the adjustment. If you wrote it off, you would look at a company that would have an enormously high return on investment and look like they did

something good. In fact, they may be having a lousy return on the money they spent which gave rise to that goodwill on the balance sheet. [Also included in 7(a)] **[TI 10/16, p. 35]**

Committee/Staff/Observer
What distinguishes goodwill from a productive asset, like a machine or other equipment which, from an economic standpoint, you paid for the same way you paid for goodwill? [Also included in 7(a)] **[TI 10/16, p. 35]**

Participant I-5
Machines get old and their value goes down; goodwill doesn't really get old. Why would [one company] have a different earnings number based on how the corporation ended up to be where they are today versus [another company]? I can't say that [one company] has more goodwill in their businesses than [another company]. I think [the latter company's] brand names are a bit better respected. So when I look at those two companies, to compare apples with apples, either both need to have the goodwill in and amortize it. The fact is both companies keep adding to their goodwill and it will probably continue growing, not depreciating. [Also included in 7(a)] **[TI 10/16, p. 35-36]**

Participant I-7
The company has made that as a specific choice in order to grow their business. I want to know about it and I want to penalize it, as opposed to somebody like [name deleted] who has it, who's growing from an internal point of view. So I won't take it out; that's a cost of growth, that's a cost of doing business. [Also included in 7(a)] **[TI 10/16, p. 37]**

Participant I-4
It's certainly an item to be reckoned with but not necessarily to penalize for. If X buys Y and incrementally the returns on buying that are far above the cost of capital, that should be an item that appreciates in value. X should be awarded something for that. [Also included in 7(a)] **[TI 10/16, p. 37]**

The way goodwill is added or taken out of the balance sheet has little to do with real world or with the ongoing fortunes or misfortunes of the company. I tend to not think about it; the goodwill number is a fill-in number. [Also included in 7(a)] **[TI 10/16, p. 38]**

Participant I-12
Goodwill is one of those things that I look at because, for purposes of the BIS capital rules, you have to write goodwill off against capital. It also brings up another issue which is going to be the most important issue to be faced by analysts, and that is comparability of our accounting and reporting systems with those overseas, as all of us become more and more oriented toward global investing. Overseas, I believe that goodwill for the most part is written off the day an acquisition is made. [Also included in 7(a) and 18(a)] **[TI 10/16, p. 38]**

Participant I-9
I consider goodwill a nuisance and a misnomer. My main complaint with it is that it prevents business transactions that I would like to see occur. The German or the Swiss drug companies would have bought some of the "doggier" U.S. drug companies, but U.S. companies would

not pay the same price because their earnings would be killed going forward. I don't think that's helping facilitate commerce. If it is a legitimate transaction, it will show up in the return on investment numbers going forward. [Also included in 7(a)] **[TI 10/16, p. 38]**

Committee/Staff/Observer
What about leases? There are capital leases and operating leases; do you capitalize operating leases? Do you make adjustments? [Also included in 8(c)] **[TI 10/16, p. 38]**

Participant I-2
I used a similar concept, "normalized earnings" on a quarterly basis. For example, for [name deleted], I take out the $280 million pension credit, I take out foreign exchange gains and losses, and I normalize the tax rate. You have to be careful not to confuse people too much because you can normalize things so much that they won't have any idea of what you are talking about. But you have to normalize on a quarterly basis. Other adjustments are gains and losses on asset sales and insurance settlements, etc. [Also included in 5(a) and 11(a)] **[TI 10/16, p. 39]**

Participant I-11
The reason that we use historical financial statements is to make forecasts about the future. A nonrecurring charge usually represents the financial recognition of some past transgressions. The market generally has recognized those transgressions in its evaluation of the stock long before the nonrecurring charge is taken. From that standpoint, the nonrecurring item is almost meaningless because the market has already discounted it and is looking ahead, not back. **[TI 10/16, p. 39]**

Participant I-9
I adjust for nonrecurring items for a while but, having been a bank stock analyst for 2 years, if a company messes up long enough, I go back and restate the records of the company as if those nonrecurring items were really a recurring part of the business. **[TI 10/16, p. 39]**

Anything you can do to work operating leases and capital leases together would be constructive from the standpoint of somebody who doesn't have the inside information of the person doing the leases, because it's almost impossible to reconcile what the financial statements say with what is actually going on in the business under the present system. [Also included in 8(c)] **[TI 10/16, p. 39]**

The number that I most want to have conviction in is currency transactions because we add them back and forth and we rely on accountants 150% to give us an accurate number. **[TI 10/16, p. 40]**

Participant I-8
Most of the nonrecurring items mean to me that the company did not earn what it said that it earned over the prior 4, 5, or 6 years. It's a one-time admission that they didn't earn that money. The minority of cases is truly nonrecurring. **[TI 10/16, p. 40]**

Participant I-12
One of the things I have done on banking companies is literally spent a lot of times over past years taking out LDC and putting that in a separate bucket. I'm not ignoring LDC because it has been a big part of the income statement because some cash flows (incoming interest income) have disappeared. So I have tried to separate that out to see what these companies can earn once that issue goes away because it is going to go away at some point. In fact, that's why I recast the entire income statement because the financial industry seems to be highly prone to special income and cost items. **[TI 10/16, p. 40]**

Basically, I've been viewing LDC as a separate segment because sometimes the market ignores the LDC for some period of time and then it may come back to haunt you. [Also included in 3(b)] **[TI 10/16, p. 40]**

Participant I -4
Would you put real estate in that? **[TI 10/16, p. 40]**

Participant I-12
LDCs are a unique phenomenon of the 70s and 80s; I don't think real estate is a unique phenomenon. It happens to be an exaggerated phenomenon at the moment, but not unique. The next LDC crisis will come, but it might be 50 or 100 years away. **[TI 10/16, p. 40]**

Participant I-6
I try to come down to what are the earnings from the current businesses that are there today, and are they going to be the same ones next year? So, if they have written off a complete line of business, I back it out and get rid of it. What I have seen from a couple of companies I follow, and what I would like to see, is two EPS numbers; one is the traditional GAAP reporting number, and one based on the earnings excluding the nonrecurrng items and comparing them to the prior period excluding the same things so that we have some comparability. But that is just starting to come out. [Also included in 2(c) and 5(a)] **[TI 10/16, p. 41]**

Participant I-1
I think it is also relevant for companies that are oriented toward mergers and acquisitions. You deal with issues of trying to compare apples to apples and trying to find out where is the real growth coming from. [Also included in 2(c)] **[TI 10/16, p. 41]**

Participant I-3
I don't make the adjustment very often because I don't have the information, but I would like to see the information about long-term contracts (1 or 2 years) entered into by companies that sell commodities. In one or two years, commodity prices can fluctuate a great deal and if a company is locked in at a particular price for a meaningful % of their potential output, I would like to know that because it changes the way you think about the revenue in the future and it is important. Even a footnote would be very useful. [Also included in 8(c)] **[TI 10/16, p. 41-42]**

Participant I-6
In line with that, I adjust earnings in those situations too because what you really have done now is to set up a new segment of business which is a financial business, not an operating business. So some companies that deals in commodities really have two lines of business; one is making the product, the other one is the financial end of selling it to a financial market and using financial tools to lock in a given revenue stream. Completely two separate businesses that should be reported under segment accounting, completely outside the traditional revenue recognition cycle. [Also included in 3(b)] **[TI 10/16, p. 43]**

Participant I-5
Adjusting for pensions is sometimes a big deal. You take a company like [name deleted] where they are accruing tremendous pension liabilities for previous years. When you look at their basic businesses, you should say that the businesses that they're in are generating this stream of earnings excluding the pension expense. Then turning to the balance sheet, you should recognize the liability as a liability and associate an interest cost with that liability or treat it as if it were a long-term obligation. **[TI 10/16, p. 43]**

Committee/Staff/Observer
For how many historical annual periods do you use financial information? Usually, companies prepare tables for 10 years or so. **[TI 10/16, p. 44]**

Participant I-8
Five. **[TI 10/16, p. 44]**

Participant I-2
Ten. **[TI 10/16, p. 44]**

Participant I-12
Ten. **[TI 10/16, p. 44]**

Participant I-9
Eleven actually (the current and the past 10 years). **[TI 10/16, p. 44]**

Participant I-1
Ten. You want to see how the company has done over different cycles. **[TI 10/16, p. 44]**

Participant I-7
Five. **[TI 10/16, p. 44]**

Participant I-4
It depends on the type of investment you are making. If you are looking at a company that has been under a new regime for the past 5 years, you may want to look at 10 years, but your analysis will focus on the years under the new regime. **[TI 10/16, p. 44]**

Committee/Staff/Observer
This relates again to financial information, but financial information that is not required in external reporting. What additional financial information do you regularly use that is not part of external reporting? [Also included in 3(c)] **[TI 10/16, p. 44]**

Participant I-6
In some commodity companies, the forward position of their sales. How much of the future production has been hedged forward and what types of hedging arrangements have been made? The hedging aspect of future sales is something we constantly discuss with management. **[TI 10/16, p. 45]**

Participant I-11
Sale and profit information by product line or product category. [Also included in 3(c)] **[TI 10/16, p. 45]**

Participant I-9
The European drug companies give you estimates of the future sales of the new products that are being introduced. You have to use that information at your own peril, but it's still a nice number to have. The other number you ask about is product pricing. **[TI 10/16, p. 45]**

Participant I-2
Information about currency hedging. I was talking to a company the other day which hedged its foreign currency against the dollar 100% for the next 12 months and 80% for the next several years. There has been a major change in their foreign currency versus the U.S. dollar. I think you should think about a hedging footnote, certainly for the extractive industry where it is important both for pricing and currency. **[TI 10/16, p. 45]**

Participant I-7
Particularly for companies that are in financial difficulty, or moving in that direction, I would like to see bank covenants. [Also included in 13] **[TI 10/16, p. 45]**

Committee/Staff/Observer
Can you demand a copy of covenants to the company? [Also included in 13] **[TI 10/16, p. 45]**

Participant I-7
I can ask for it. Let me follow with another point. Especially in the financial area, if companies are setting up reserves, I would like to see when the reserves are used. I would like a stream of information as the assets are written off about what part of the reserves has been applied against those assets. [Also included in 5(b) and 13] **[TI 10/16, p. 45-46]**

Participant I-5
Generally speaking, you can get the bank covenants directly from the SEC even though the company will not send them to you directly. Similarly, you can get AIS-4 registrations from the SEC well before you can get a preliminary statement out of the company, and the documents available are listed in the exhibits to the 10-K. Although the detail is there at the

SEC, the company won't send it to you and they don't let you know that it's there. [Also included in 13] **[TI 10/16, p. 46]**

Participant I-12
Any financial business ought to be reporting an average balance sheet and the accounting for the loss reserves. The year end balance sheet can totally distort the entire enterprise. [Also included in 5(b)] **[TI 10/16, p. 46]**

Participant I-1
The point about the treatment of the reserves is an excellent one. Breaking out the reserves from the general accruals category would be worthwhile because when you do have reserves year after year, you don't know what is in there. And as they are applied, some information as to how they are applied to specific assets and how they are relieved is a terrific idea. [Also included in 5(b)] **[TI 10/16, p. 46]**

In the way of additional information, a break up between maintenance and gross capital expense and the same for R&D would be worthwhile. On the revenue side, price volume information is provided by some companies; for example, supermarkets provide that information. [Also included in 5(b) and 13] **[TI 10/16, p. 46]**

Participant I-8
You have to get more information than what is in the annual report and the source of most of the additional information you get is the management of the company. Another source is the trade press (rate of growth, market share). **[TI 10/16, p. 46]**

Participant I-4
A very important piece of information is the proxy material. We use it because in a lot of cases, there are different types of programs that have a lot to do with bonuses, options, SARs, different things that are important. The proxy statement is as important as the other sources of information we have talked about today; however, reading a proxy statement is always extraordinary confusing but it eventually helps us understand better the company. In the 25 years I have been in this business, when I go to a conference where a company is appearing for the first time and brings a folder of information, one out a 100 companies includes a proxy. It's extraordinary that an analyst meeting a company for the first time never has that material. [Also included in 13] **[TI 10/16, p. 47]**

Participant I-10
I agree with [participant I-4] about the usefulness of a proxy statement. A lot of the flagrant abuses of stockholders' money have shown up in proxy statements. Often times when you confront management with an issue which is just alluded to in the proxy statement, management is hypersensitive about it because they know they're trying to conceal something from their stockholders. The proxy statement tells you something about the ethics of the people you're dealing with. [Also included in 13] **[TI 10/16, p. 47]**

Participant I-8

I am on the mailing list of a lot of corporations without being a stockholder. The information that comes out never includes a proxy. When you get the annual report, you don't get a proxy statement unless you're a stockholder. [Also included in 13] **[TI 10/16, p. 47]**

Participant I-4
It should just be mandatory that the proxy statement be a part of financial reporting. [Also included in 13] **[TI 10/16, p. 47]**

Participant I-1
When you call for financial information, you can make 2, 3 or 4 requests before that proxy finds its way to your office. [Also included in 13] **[TI 10/16, p. 48]**

Participant I-6
The proxy statement has a lot of useful information and it is extremely difficult to get. It would help if it could be put into a standardized form as part of financial reporting. One of the most flagrant examples of misinformation I found in a proxy statement was when a board member's salary was the only one in the entire place that was put in there per month instead of on an annual basis. [Also included in 13] **[TI 10/16, p. 48]**

Committee/Staff/Observer
Nobody . . . brought up projected or forecasted financial information. I realize you all have your models and do what you have to do with the information, but do you get from somebody outside of your own machinations a statement of forecasted information? [Also included in 12] **[TI 10/16, p. 48]**

Participant I-11
Some companies will give you their forecast, some on a regular basis, some only when something extraordinary has happened. Obviously, if they give you that information and you use it, you should use it with caution. [Also included in 12] **[TI 10/16, p. 48]**

Participant I-10
Most companies will give you an objective they are trying to achieve or enough information to derive what implications for growth are by the things they tell you. I have not found too many companies unwilling to do that. [Also included in 12] **[TI 10/16, p. 48]**

Participant I-9
How about requiring in financial reporting that a company submit at least the next year's projected results? [Also included in 12] **[TI 10/16, p. 48]**

Participant I-10
I think it's crazy. [Also included in 12] **[TI 10/16, p. 48]**

Participant I-1
A lot of companies stand behind the veil of "we're not allowed to give projections". But there are a few brave souls; one company we're involved with put a five year projection in the annual report and in the chairman's letter. [Also included in 12] **[TI 10/16, p. 49]**

Committee/Staff/Observer
We're certainly not talking about requiring a 5 year projection, but perhaps asking management to put a one year projection. It seems to be that management ought to have an idea of where they're going for the next year. [Also included in 12] **[TI 10/16, p. 49]**

Participant I-7
We have become a very litigious society. Until the society changes, I think that puts a great deal of burden on the company and its investors to require companies to come up with specific projections. [Also included in 12] **[TI 10/16, p. 49]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the way they use information to achieve their objectives, some investors made a few additional comments on the types of information they use.

Participant I-9
One thing for the committee to consider on the previous question [related to the types of information investors use]. Look at the "other income" line of the company going forward. You're going to have joint ventures and a more complex world. The "other income" line was set up to net interest income and interest expense and when you put [names deleted] and all these deals in there, this line can go from $10 to $200 million in 3 years and it's not adequately reported now. [Also included in 5(a) and 6] **[TI 10/16, p. 51]**

Participant I-7
Especially in this kind of environment where an increasing number of companies are taking significant charge offs that can go in excess of $1 billion, it gets back to the cash flow issue. At the time of the charge off, it's a non-cash flow issue, but to the extent that a good portion of those dollars are going to be used either to lay people off over a period of time or to physically close plans, I would like to get some sense of how that cash has been used out of that restructuring charge. [Also included in 5(b)] **[TI 10/16, p. 56]**

Participant I-1
It goes back to relieving the reserve account. [Also included in 5(b)] **[TI 10/16, p. 56]**

Participant I-2
If we go back to the point made earlier about hedging. Probably irrelevant for two-thirds of the businesses but for us it is imperative. There is a company, [name deleted], who sold forward aluminum at a high price at the peak of the market, very clever on management's part, and the market collapsed and they got 2 or 3 years of phenomenal profitability long after the commodity price had collapsed. They felt that they would be able to dovetail that with a recovery in the market but the market never recovered. So what you had was a surreal situation where they had very strong profitability in an environment where that was not going

to be duplicated. Unless you knew that, it wasn't obvious to you and you could make a major mistake. Our companies are now doing much more hedging and they won't tell us what they pay for a hedge; it's important to us to be able to make a judgment as to whether they paid a smart price for the hedge. It's also important to consider how long they're hedged for. [Also included in 19] **[TI 10/16, p. 56-57]**

Participant I-12
And I would add financial instruments to the list. [Also included in 19] **[TI 10/16, p. 57]**

[Context] Responses to the postmeeting questionnaire to the October 16, 1992 Investor Discussion Group meeting.

QUESTION 1

Propositions:

- The objective of external reporting is to provide information that is useful to present and potential investors and creditors and others in making rational investment, credit, and similar decisions, which involve whether or not to commit, or continue to commit, resources to a particular company in expectation of receiving compensation, usually in cash, from the company or in the markets for its debt and equity securities.
- The cash flow prospects of suppliers and employees who expect to be paid for the goods and services they sell to the company, lenders and investors in debt securities who expect to be repaid with interest for amounts the company has borrowed, and stockholders who expect dividends and increases in market prices of their shares of stock depend significantly on the company's own ability to bring in more cash than it spends on resources—to use the resources it receives to produce goods or services for sale to customers at a profit.
- External reporting therefore attempts to provide information—primarily accounting information—that is useful to present and potential investors and creditors and others in assessing the amounts, timing, and uncertainty of the company's prospective cash flows.
- Information useful for investment, credit, and similar decisions that accounting can provide is financial information about the assets, liabilities, and stockholders' equity of a company and the effects of transactions and other events and circumstances that change assets, liabilities, and equity, including information about the company's cash receipts and payments and its earnings.
- Earnings generally is a better indicator of a company's cash flow prospects than information about its current cash receipts and payments because to a significant extent current cash flows result from past operations and constitute investments in future operations and do not represent consequences of current operations or good predictors of cash flows of future periods.

Do you generally accept that set of propositions?

Yes	*7*
No	*1*

Yes	*Suggested Changes to the Propositions*
Participant I-7	Fifth bullet point very significantly.
Participant I-17	I would not overlook the value of external reporting as a way to evaluate the capability of management over time. It can give insight as to how management views its business opportunities, what strategies are being employed, and how well it executes those strategies.
Participant I-8	I'm not totally sure what the last bullet says, but I don't think I accept it. The expectation for either earnings or cash flow in a future period must start with some estimate of future revenues. The relationship of either past cash flow or past earnings to past revenues is the best place to start an estimate of future results.

No	*Suggested Changes to the Propositions*
Participant I-9	The purpose of external reporting is to accurately portray a company's financial position at a given point in time and to portray accurately its earning power for a given past period (quarter, year). This portrayal should note any significant changes in known major items that might cause these reports to mislead--i.e. pensions, leases, non-recurring charges, currency, etc. The function of these reports is to establish a base from which to project the future profitability of the business over a 3 to 5 year period. The base is obviously helpful in determining future earning power but it is not in my opinion the job of external reports to make future projections. The reports are primarily past oriented and it is the job of the analyst to obtain from questioning management whether past performance is indicative of the future.

[PMQI 10/16, p.1-2]

QUESTION 5

This question relates to the adjustments investors make to financial information obtained through financial reports to achieve their objectives.

a. At the meeting, nonrecurring items were the most frequently mentioned type of adjustments to income or cash flow statements. It was also mentioned that it is often difficult to determine whether an item is really nonrecurring. Do you usually adjust earnings or cash flows for the following "nonrecurring items"?

	Yes	*No Response*
Results of discontinued businesses	*8*	*1*
Effects of restructuring provisions	*9*	
Effects of irregular tax rates	*4*	*5*
Significant gains or losses on sales of fixed assets	*9*	
Significant gains or losses on sales of receivables	*7*	*2*
Significant gains or losses on sales of debt securities	*8*	*1*
Significant write-downs of fixed assets	*9*	
Significant write-downs of receivables	*7*	*2*
Significant write-downs of investments in debt securities	*6*	*3*
Significant write-downs of inventories	*7*	*2*

	Comments
Participant I-17	The key word in the question is "usually." You have to be reasonably certain that management is truly converting a problem with a "one-time" action. Increasingly (as one restructuring provision is followed by another) we are finding this is not the case.
Participant I-8	Many of the yeses should be qualified by "it all depends." For example, a receivable write down because of a customer bankruptcy might be viewed differently from a writedown judged to be because the company offered terms that were "too aggressive."
Participant I-11	The decision to adjust depends on the apparent probability that the "nonrecurring item" represents the recognition of past events which are in fact unlikely to recur.
Participant I-12	Most analysts are unable to predict tax rates & typically have no choice but to base estimates on management's assessment of "core" tax rates. I organize my earnings models in the following categories: Income - 1)stable income, 2)trading, 3) capital gains & losses, 4) all other; Expenses: 1)staff, 2) loss provision, 3) premises, 4) communications, 5) all other

b. Do you usually adjust earnings or cash flows for the following items that are not reported in the income or cash flow statements?

	Yes	*No Response*
Environmental claims	*2*	*7*
Litigation claims	*2*	*7*
Additional bad debt reserves for receivables	*3*	*6*
Gains or losses on off-balance-sheet items (forward contracts, interest rate and currency swaps, etc.)	*3*	*6*

Participant I-7	Contract gains or losses taken into future earnings considerations.
Participant I-17	Obviously, such items are adjusted only if they are considerably larger than normal, for example, some level of litigation and environmental claims are normal.
Participant I-9	[Regarding gains or losses on off-balance sheet items] No information to do so.
Participant I-11	I will note the existence of such claims if they are material, but uncertainties of timing and magnitude make it unrealistic to quantify them precisely.
Participant I-12	For valuation purposes, I always look at the net change in the investment portfolio - it is only one of many valuation (not earnings related) factors unless the company appears to be approaching bankruptcy.

c. What other adjustments do you usually make to information obtained from financial reports (including balance sheet, income statement, cash flow statement)?

	Yes	*No Response*
Pension costs	2	7
Pension liabilities (balance sheet adjustment)	1	8
Goodwill amortization added back	6	3
Goodwill asset deducted from total assets and equity	4	5
Environmental liabilities (balance sheet adjustment)	1	8
Operating leases capitalized as assets	2	7

d. It was mentioned at the meeting that some adjustments are not made or are difficult to make because of a lack of adequate information in financial reports. Which potential adjustments would you include in that category?

	Yes	*No Response*
Future sales price fixed by forward contracts	8	1
Effects of other hedging instruments on earnings or cash flows	8	1
Environmental claims or liabilities	5	4
Litigation claims	5	4
Leases	4	5
Pension costs	7	2

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	Comments
Participant I-17	In litigation and environmental claims, it depends on the size of those items relative to an estimated "normal" range.
Participant I-9	I would like to make adjustments for leases, pensions, and health benefits but I distrust the numbers in the financial statements. Also leases for retailers.
Participant I-11	It's more an issue of uncertainty than lack of information in most cases.
Participant I-12	The entire arena of swaps, hedges, derivatives, is confusing to analysts. We "know" that current reporting requirements seem distortive, but we don't understand the instruments sufficiently well to assess their real economic impact - both risk and reward- on company's earning power. Ergo, we fret and worry and wigh we had more meaningful info. to work with.

[PMQI 10/16, p. 24-25]

QUESTION 6

At the meeting, you identified and discussed categories of financial information that you regularly use that is not part of external reporting. Those categories are listed in the table below, which has columns at the right for marking answers to the following three questions:

- Question 1: Please indicate how often you obtain and use the information listed by entering the applicable letter (right) in the first column of the table.

  F for Frequently
  O for Occasionally
  R1 for Rarely because I have difficulty getting the information
  R2 for Rarely because I do not find the information useful.

- Question 2: Please identify your source(s) of each kind of information listed by entering the applicable letter(s) (right) in the second column of the table.

  M for Discussion with Management
  P for Presentations by Management
  T for Industry or Trade Associations
  C for Discussion with Competitors, Customers, or Suppliers
  Other. Please identify

- Question 3: Please indicate in the Yes or No column of the table whether or not the information should be required to be provided by external reporting. If your answer is no, explain why by entering the applicable letter (right) in the final column of the table.

  S for Existing Sources Satisfactory
  N for Company not Best Source
  H for Disclosure could Harm the Company's Competitive Position
  B for Cost to the Company exceeds the Benefits of the information
  Other. Please identify

Question 6 (continued)

	Question 1 Frequency	Question 2 Sources	Question 3		
			Yes	No	Explain No
• More detailed information about unusual, infrequent, or nonrecurring items	*Frequently:* 7	M-6;P-4	5	1	S-1
	Occasionally: 2	M-2;P-2	2		
• More detailed information about industry or geographic segments, or information about segments not separately identified in the segment footnote	*Frequently:* 7	M-6;P-5; T-3;C-2	6		
	Occasionally: 1	M-1;P-1	1		
	Rarely[1]: 1	M-1;P-1	1		
• Quarterly information in similar detail as available annually	*Frequently:* 7	M-6;P-5; T-1	6		
	Rarely[1]: 1	M-1;P-1		1	B-1
	Rarely[2]: 1			1	B-1
• Information about long-term contracts to purchase or sell products at fixed prices	*Frequently:* 3	M-3;P-2; T-2;C-1	2		
	Occasionally: 3	M-2;P-1		3	H-3
	Rarely[1]: 1	M-1;P-1	1		
	Rarely[2]: 2	M-1	1	1	B-1;N-1
• Information about transactions intended to reduce a company's exposure to exchange rate changes	*Frequently:* 2	M-2;P-1	2		
	Occasionally: 2	M-1;P-1	2		
	Rarely[1]: 4	M-4;P-4	4		
	Rarely[2]: 1	M-1			
• Projected revenues for new products or services	*Frequently:* 6	M-6;P-4; T-3; C-1	1	4	H-3;S-1
	Occasionally: 2	M-1;P-1		2	H-2;B-1
	Rarely[1]: 1	M-1;P-1		1	H-1
• The identity and nature of key covenants in debt contracts	*Frequently:* 1	M-1;P-1			
	Occasionally: 1	M-1		1	S-1
	Rarely[1]: 5	M-4;P-2	5		
	Rarely[2]: 2	M-2;P-1		1	B-1;N-1
• Average amounts of assets and liabilities for financial institutions	*Frequently:* 3	M-3;P-1	2		
	Rarely[1]: 1		1		
	Rarely[2]: 3	M-2;P-1	1	2	S-1
	N/A: 2				

Question 6 (continued)

	Question 1 Frequency		Question 2 Sources	Question 3		
				Yes	No	Explain No
• More detailed information about the activity and ending balance of key reserve accounts	*Frequently:*	*3*	M-3;P-1	1		
	Occasionally	*1:*	M-1;P-1	1		
	Rarely[1]:	*4*	M-2;P-2	4		
	Rarely[2]:	*1*	M-1		1	S-1
• The price and volume components of changes in revenues	*Frequently:*	*8*	M-7;P-6	6	1	H-1;B-1
	Occasionally:	*1*	M-1;P-1	1		
• More detailed information about the nature of stock awards and other incentive compensation arrangements with management	*Frequently:*	*2*	M-2;P-1	1		
	Occasionally:	*6*	M-5;P-5; T-1	5	1	S-1
	Rarely[2]:	*1*	M-1		1	S-1
• More detailed information about the company's cost structure such as the relationship between volume and costs	*Frequently:*	*8*	M-7;P-6; T-2	5	2	S-1;H-1; B-1
	Occasionally:	*1*	M-1		1	H-1;S-1
• More detailed information about environmental-related claims and other contingent liabilities	*Frequently:*	*3*	M-3;P-2; T-2;C-1	2		
	Occasionally:	*4*	M-3;P-2	3	1	S-1
	Rarely[1]	*1*	M-1;P-1	1		
	Rarely[2]	*1*	M-1		1	
• More detailed information about interest rate swaps and derivative products that transfer risk from one entity to another	*Frequently:*	*1*	M-1	1		
	Occasionally:	*1*		1		
	Rarely[1]:	*3*	M-3;P-3; T-1; C-1	3		
	Rarely[2]:	*3*	M-1;P-1		2	H-1;B-1; O-1
	N/A:	*1*				

[PMQI 10/16, p. 26-28]

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on the types of information investors use to achieve their objectives.

Participant I-12
The primary fair value item that financial analysts look at is cost vs market in the investment portfolio. I look at that periodically to see if a company has gains or losses, and then I look at what cash flows those assets are generating. I don't use it very much. I typically will look at a company and make adjustments depending on the environment. For that, I use average

balance sheets; that's what is useful to me. Fair value disclosure is really not of that much use. [Also included in 4] **[TI 1/13, p. 10]**

Committee/Staff/Observer
That's the next question. This question is how do you use fair value information that is available now? Or if you had more, how would you use it? For example, if you're looking at a company that paid $4 an acre for real estate, and you know that they sold one acre for $100,000, would you use that information? [Also included in 4] **[TI 1/13, p. 11]**

Participant I-8
I would try to in a security analysis sense, not in an accounting sense. [Also included in 4] **[TI 1/13, p. 11]**

Participant I-14
I think we all make the mental adjustment and use fair value a lot more than we're willing to admit. That's part of our job because what we're trying to do is determine earning power, fair value of a whole company, as compared to the price of its paper. How many times do you look at the current price for a semiconductor and you look at a balance sheet and there is $50 million of inventory that you know has just gone down; you make that adjustment. This is ongoing and we do it all the time. I would opt for fair value on a notational basis. [Also included in 4] **[TI 1/13, p. 11]**

Participant I-8
You are in some sense already using fair value when you accept the depreciation life that the management of the company is giving for the manufacturing assets. [Also included in 4] **[TI 1/13, p. 12]**

Committee/Staff/Observer
That's an impairment concept. It's the lower of cost or market concept as opposed to fair value. I agree with what [participant I-7] said, that we do make reserves to make sure that the values are at least realizable. But on the upside, taking the example of the semiconductor, we don't, even notationally, talk right now about the increase in value of that inventory. [Also included in 4] **[TI 1/13, p. 12]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting. During the discussion, a comment was made on the types of information investors use to achieve their objectives.

Committee/Staff/Observer
We hear that analysts want 11 years of information. You're suggesting one quarter? [Also included in 2(c) and 11(b)] **[TI 3/17, p. 38]**

Participant I-7
[I]t's not 11 years, it's 10 years. And we only want 10 if there is consistency. For example, I have companies that are selling businesses every 3 years. Under APB 30, they will go back and only give you 2 or 3 years of historical performance. We have a problem with companies that every several years do something so significant that the historical pattern of earnings or operating returns has been lost. [Also included in 2(c) and 11(b)] **[TI 3/17, p. 39]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches.

Participant C-5
We rely very little on the financial statement as a basis for evaluating collateralized assets. We clearly use alternative sources. We're not satisfied with the ability to make those determinations based on the financial statements. We look at business valuation and customer viability based on financial statements, but banks have traditionally developed other systems for collateral valuation. So, if assessing payment through collateral is part of the definition of what our objective is, it is one of ours, but is it an objective that is satisfied or could be satisfied by the financial statements, that's more of a question. [Also included in 1(a)] **[TC 12/8, p. 4]**

Participant C-6
Just to pick up a little bit on what [participant C-9] said, but from a different point of view, looking at, again, privately-held companies, which is what we deal with. We look at granting credit in a very traditional way, looking at historical information. We don't place a lot of faith on projections, and we look at a very traditional aspect of cash flow: profitability. As far as asset value, we place a fair amount of emphasis on asset value, meaning the primary assets of the companies that we deal with (accounts receivable and inventory) and knowing what those assets comprise of, and what the quality of those assets are, which is of utmost importance to us. [Also included in 1(a) and 4] **[TC 12/8, p. 11-12]**

Participant C-1
The other problem we have is that each of the different forms of public information you have all have different information. It's very difficult to go from a proxy statement or from a 10K to a 10Q, and to go back. So the seasonality of cash flow-- and that's what really we've found has tripped up most companies is the seasonality of cash flow--is important, but also sometimes very difficult to go back and forth between. [Also included in 1(a) and 2(d)] **[TC 12/8, p. 12]**

Committee/Staff/Observer
Question 4 moves us to a different area, and that is a question of categories of information, trying to look and ask ourselves whether or not the level of depth and breadth of information you're getting from external reporting is what you really need or use. There are four

categories identified--the general economy, the industry in which the company participates, the company itself, and then the segments of the company. Do you currently use business information in each of these categories, and if so do you have some priorities? How do you get this information, particularly private versus public companies? And are there any categories above where you simply cannot get acceptable information? **[TC 12/8, p. 17]**

Participant C-1
Segment information is probably the most difficult information to get. One of the key examples is [name deleted] with [its] credit; they were required to consolidate that and they did, and all of a sudden when they ended up selling it, people began to realize it was such a significant part of cash flow. You can break segments down any way you want (for example, foreign versus domestic) and the ability to look at earnings and cash flow on either one, or different lines of business. It's very hard to look at segment information. [Also included in 3(a)] **[TC 12/8, p. 18]**

Committee/Staff/Observer
I think the message is clear on segments, and I've got some more things I'd like to ask you about segments, but can we look at the other categories of information just briefly, on page nine, that talk about the general economy and the broader notion of industry; that is rather than industry within the company, we're talking about the industry outside the company. Looking at the information that's highlighted on page four with respect to general economy and the industry, is there other information that you particularly use? **[TC 12/8, p. 23]**

Participant C-15
This was alluded to before, and this is the whole concept of management strategy and management philosophy. I'm not quite sure how that could be incorporated into financial statements because it's soft-type information. But that's probably the most important thing that we could be looking at, because if a company has a change in philosophy or a change in strategy, and they decide they want to lever up or enter into a new business, that's going to have a dramatic impact on the capital structure and their credit worthiness. I think that there are parts of financial reports where management discusses historical operations, historical earnings, and maybe there should be a segment in there where management talks about their philosophy, or their strategy going forward. Ultimately that is more important than historical information or as important. **[TC 12/8, p. 24]**

Participant C-9
I'll start out by seconding that; the final leap of faith is management. Also, in the general economy, I would look to an interest rate outlook; in that regard I'd probably rely on a variety of economists and general information. To give an example of how you can use some of the general economy information; I was once asked to look at a particular [name deleted] plan as a lessor, and I had to look at all the trends in health care plans, and real estate, and kind of an interesting situation, but it brought in sort of all of these elements that you're talking about, and they were very critical in making an assessment. **[TC 12/8, p. 24]**

Participant C-13
I've got two separate observations about the non-segment part of this question. One is that while we rely very heavily on general economic data, we rely relatively little on industry data in the way in which you've described it here. First, the data is kind of nebulous at best; in virtually every case definitions vary. We do rely on our analysts to understand is the second bullet, which is basically much more nonfinancial information. But in terms of aggregating industry data, we don't find that particularly useful. **[TC 12/8, p. 24]**

Second, an entirely unrelated observation would be that in the area of company data, I think it would be very helpful to us to get a sense of the distinction between fixed and variable costs. [Also included in 5(a)] **[TC 12/8, p. 25]**

Participant C-5
We have specialized industry groups that focus on an industry. But the larger part of this (information about the general economy) is really taken out of the context of the individual analyst, and there are some bigger decisions made about where we want to go, what our portfolio limit is for a particular industry. The idea of getting all this by customer in individual financial statements is not something that would roll into a process. I'd like it in a format that supplements my analysis, but I'm not going to use it in that format. **[TC 12/8, p. 25]**

Participant C-12
I'd almost go farther and say that in terms of getting economic background or industry background, not only do I not get it from the company most of the time, I would rather not get it from the company. I'd rather go out and do my own work on the economy, on the industry, and not get it filtered through management. **[TC 12/8, p. 25]**

Committee/Staff/Observer
But wouldn't you take your original research in the economy or the industry, and then contrast that with management's opinion on what the environment is that they're operating within? And then try to determine whether they're consistent or why they're not consistent? **[TC 12/8, p. 25]**

Participant C-11
It seems to me it's pretty important to do that if you have the opportunity to sit down and meet with management, and get some forecasts or projections, it's important to know the underlying assumptions. Then you can do your own research to see if they're reasonable or not. [Also included in 12] **[TC 12/8, p. 25]**

Participant C-4
I think there was a question in here as to when we get this information. I would say the better the credit risk, the less information we get, and the less willing management is to provide that information. So I could see some benefit to giving some standardized information to enhance our underwriting of various risks. [Also included in 2(c)] **[TC 12/8, p. 26]**

Participant C-7
Looking at it from a bank creditor, especially in the small and middle market type companies we deal with, our focus would be on company and industry information. Typically it's provided by the borrower. You know, if we're doing our job, we're out meeting with management, let's say, quarterly. We find that's really the key to get this type of information. **[TC 12/8, p. 26]**

Committee/Staff/Observer
So far the committee has not detected any perceptible interest in reducing the information we provide. We've tried this question several different ways--what would you like for us not to report? We're getting universal, we want everything, we don't have to use it all, but we want everything. We hear things like information overload at the same time. Is there a problem in the way information is communicated in financial statements? That is, is there some way we can make it more usable, more readable? **[TC 12/8, p. 40]**

Participant C-5
I think the direct method of cash flow reporting is something that I think is overdue. We end up reconverting everything that we receive on a cash flow format. So that's just a simple one of format and readability and understandability that I think would go a long way. I don't know how to emphasize that enough. [Also included in 5(c)] **[TC 12/8, p. 40]**

Committee/Staff/Observer
I'd like to follow up on that. When we've had FASB 95 out for five years, most users and most preparers and auditors use the indirect method. I've tried to challenge in my own practice why I should go the direct method, and I'd love to understand what the information content is there that you're looking for? [Also included in 5(c)] **[TC 12/8, p. 40]**

Participant C-5
For me, I'm a financial analyst as well as an accountant, and I think the source of the information is more fitted to the indirect method, but the use of the information is fitted to the direct method. [Also included in 5(c)] **[TC 12/8, p. 41]**

Participant C-14
I perceive a lot of the overload to be in the footnotes, but I also find the footnotes to be the most useful part of the financial statements. And I tried to think of how to enhance the understandability of that information, and I think we started to touch on it when we said well, in the footnotes you find the nominal amount of the swaps, but you really don't know what the impact could be. We also need information on the assumptions used by a company or the reasoning for the assumptions they chose in their accounting methods. For instance, why did [one company] pick a 12% return on plant assets, it's 11 or 12%, when inflation is you know, 3 or 4%? Or why did [another company] depreciate its video over 36 months when the economic life is only four months? I'd like to know more about why they choose those kind of things. Or other examples would be why they've changed accounting standards. [Also included in 2(a), 2(c), 9, and 19] **[TC 12/8, p. 41]**

Participant C-11
I just would like to emphasize the same point that [participant C-14] made. I think that the newer accounting opinions are all complicated, and each one of them seems to require a page of footnote. The example that we were talking about before, I think, is a very good one, and that's the off-balance-sheet liabilities. It goes on forever, it's boilerplate, and it doesn't give any analytical information whatsoever. All you know is that there's lots of stuff out there. This is not an easy thing to implement, but I think that as new accounting opinions come and new footnotes have to be written, I think the question has to be what is the most important information to be found or disclosed on this subject matter. If there is not analytical content in the footnote that it's not really worthwhile. [Also included in 19] **[TC 12/8, p. 42]**

Participant C-1
The only comment I have on direct versus indirect cash flows is that I've had one company report both. It's very nice to have direct cash flow. The problem is that you can never jibe the two, it never worked, and there was always a different number for direct versus indirect, and they were never consistent. [Also included in 5(c)] **[TC 12/8, p. 42]**

Committee/Staff/Observer
I'd like to ask those who deal with small private companies if you are hearing from those that you loan to, your customers, complaints about the high cost of complying or preparing financial statements under the standards? Everything we're hearing basically is kind of adding to this, and yet one of the reasons that we're here, I think, also is this concept that there is a tremendous cost to the information overload requirements we currently have. Are you hearing from your customers a problem with cost overload? [Also included in 2(d)] **[TC 12/8, p. 42]**

Participant C-5
We are typically getting an income statement and a balance sheet, we are not getting a statement of cash flows, or we're not getting a statement of capital changes. What concerns us is the need to establish some standards for the degree of verification that might go on. Rather than asking for more disclosure, we would trade that for some verification at that level, an audit verification. [Also included in 2(d) and 17(b)] **[TC 12/8, p. 43]**

Participant C-8
We've often done the opposite, and agreed to forego the verification for more disclosure, more schedules of the various assets and liabilities on the balance sheet. [Also included in 2(d) and 17(b)] **[TC 12/8, p. 43]**

Participant C-9
If there is a certain amount of information which is not required, then we as lenders have to ask for that kind of information, and that is a little bit of a dance and a subtlety to get an understanding of management and their integrity. Some of my better decisions have been when I haven't gotten the answer; in those cases, I say no. And you find years later that there was fraud involved. So, to a certain extent there is a value in not getting all of the information on paper. **[TC 12/8, p. 44]**

Committee/Staff/Observer
Question 10 talks about the adjustments that users make to the current external reporting they get for whatever purposes they need. And it cites several different examples of things that might be adjusted by users to theoretically make the reporting more useful. It talks about the effects of non-cash charges or non-recurring charges, capitalization of leases that were otherwise accounted for as operating leases, over and under-funded pension plans, off-balance-sheet matters, purchased goodwill, and deferred income taxes, differential accounting between entities, etc. The question is: for each of these areas in which you adjust the financial information, could you please describe what you adjust, and how you make that determination? **[TC 12/8, p. 44]**

Participant C-10
Just to start on one point here, capital expenditures. We'll try to separate out the normal routine maintenance capital expenditure from the unusual. **[TC 12/8, p. 44]**

Participant C-11
Non-recurring items: the problem is that companies report non-recurring items, or sometimes they don't, but they are non-recurring. The problem is that the word is used in different ways. I think each person doing the adjustments has to figure out what they consider to be an unusual and non-recurring item as differentiated from items that are really management's making timing differences and making cosmetically things look better the next quarter, or something or other. So I think it's a matter of where an individual analyst is going to determine the kinds of things they think are non-recurring, and not necessarily take what management says, per se, as non-recurring. **[TC 12/8, p. 44-45]**

Participant C-12
The first adjustment I make is always for non-recurring items, but I tend to separate that into two categories. There are certain things that I consider really aren't going to happen again: Selling a subsidiary, a major subsidiary, say, for a profit. On the other hand, there are things which may be non-recurring, depending on the external environment: the ability to sell residuals, the ability to sell securities. There's more than one type of non-recurring. **[TC 12/8, p. 45]**

Participant C-1
We generally adjust for as many non-cash charges as we can determine. Amortization, depreciation, ESOP expenses, SARs. Some companies are more user friendly than others in disclosing specifically what those are. Non-recurring items: selling a division, strikes, if possible. Generally, management is telling you why their numbers are so poor because it's some sort of non-recurring number. Operating leases, depending on the type of company and on the magnitude of the operating leases. And the adjustment process is trying to work into intrinsic value. Most of the types of companies that we look at don't have pension plans so we don't have to worry about it. Environmental liabilities and litigation risk is one of the things we spend a lot more time looking at. That's something you get more from management. [Also included in 8(c)] **[TC 12/8, p. 45]**

Participant C-15
I think that going forward, the adjustments that we're going to have to make for FASB 106 are going to make everything historically pale by comparison. And that's going to be a real issue in terms of what the disclosures are going to be and trying to get comparabilities when some companies choose to amortize the funded liability, and some companies are writing it off. [Also included in 2(c)] **[TC 12/8, p. 45-46]**

Participant C-3
In comparing different capital structures, we may adjust earnings for preferred stock dividends. Again, asset quality is another adjustment that we make to earnings, for example the adequacy of reserves. **[TC 12/8, p. 46]**

Participant C-14
The only item that I could come up with that wasn't here was capitalized expenses; to look at the nature of different kinds of capitalized expenses, particularly capitalized interest, and try to determine whether this is a matter of routine or not, and whether it's more appropriately viewed as an offset to earnings. **[TC 12/8, p. 46]**

Participant C-5
Management salaries are important in the small company environment. And those typically we don't get broken out. We also deconsolidate finance companies from the consolidated financial statements of commercial companies. [Also included in 5(a)] **[TC 12/8, p. 46]**

Participant C-4
Several adjustments. We may give credibility to the LIFO reserve, depending on the price trends and inventories. On the contractor's level, we will normally eliminate under and over billing accounts, and add in available gross profit to working capital, and then compare that to annual overhead to see if the backlog is adequate. If it's not, what steps is management taking to rectify that problem? That's more an analysis of the cash flow looking forward than your accrual accounting. **[TC 12/8, p. 46]**

Participant C-6
For private companies, management salaries and profit-sharing contributions will be looked at, and also T&E will be looked at. **[TC 12/8, p. 47]**

Participant C-9
Discretionary type of expenses. **[TC 12/8, p. 47]**

Participant C-3
Servicing value for mortgage banks, for example. Other assets that might be salable that appear on the balance sheet at historical cost. **[TC 12/8, p. 47]**

Committee/Staff/Observer
[Participant C-1] mentioned operating leases and adjusting for operating leases. Do others adjust for operating leases? And can you tell us a little bit about what you do and what you try to accomplish? [Also included in 8(c)] **[TC 12/8, p. 47]**

Participant C-5
We adjust them back as if they're capitalized leases, for retailers, in particular. It's industry by industry. Transportation, as well. [Also included in 8(c)] **[TC 12/8, p. 47]**

Committee/Staff/Observer
So you're capitalizing the operating leases? [Also included in 8(c)] **[TC 12/8, p. 47]**

Participant C-5
Yes, for analysis purposes, for leveraged calculations as well as interest cover, too. We would look at our interest cover based on a lease. [Also included in 8(c)] **[TC 12/8, p. 47]**

Committee/Staff/Observer
Question 11. How many annual historical periods do you use financial information in doing your financial analysis? How many periods do you look at in doing your analysis? **[TC 12/8, p. 47]**

Participant C-11
I think this will vary by the type of work you're doing, and the changes that might have occurred in an industry in recent years, so that something that happened earlier may be totally irrelevant in terms of what's going on. In the kinds of companies I follow in this situation, I would tend to take 11 years. This would be relevant for medium and larger sized companies; I want to see how a company moved through a series of economic changes, and until recently we had an unusually long number of years, for instance, where the economy wasn't in serious recession. So, unless you went back into the late seventies and early eighties, where you had both recession and high interest rates, you just didn't see how something happened. **[TC 12/8, p. 48]**

Participant C-13
I think in principle what you need is a full business cycle. I think that's basically what [participant C-1]'s arriving at. That may vary from industry to industry, and because that's open to a fair amount of interpretation as to what that means, I think you have to fall back on some arbitrary standard. For instance in the case of property and casualty industries, to get a full business cycle you've got to go back to 1983 from 1992. I think you fall back on a relatively long period in order to be able to cover these kinds of things, and I'd also suggest that 11 years is appropriate. **[TC 12/8, p. 48]**

Participant C-16
I think it's going to differ on the user and the nature and the amount of credit being extended. To the extent that it's a trade creditor extending credit; one year financial, two years is fine. In the equipment leasing business, aside from the very large transactions it's typically three years. **[TC 12/8, p. 48]**

Participant C-4
Most contractors can't survive for 11 years. We usually look at five years. **[TC 12/8, p. 48]**

Participant C-5
I would say we have maximum bank credit maturities of about seven years. I would say right now we're using five years, trying to get back to some pre-recession core earnings just to have an understanding of those points. I would imagine, as we roll out of this, we'll probably look to the nadir of the recession at some point to get an understanding of how bad things can get again. But it's a flexible horizon, three to five years. **[TC 12/8, p. 49]**

Participant C-2
Yes, I would agree with that. I think looking very closely at trends over, say, three to five years, but kind of notionally back beyond that as far as the company's ability to manage through difficult times. **[TC 12/8, p. 49]**

Participant C-1
We generally are looking at three to five years. We're spending more time looking forward than looking back. The other thing that we quite often look at is how companies did coming out of the last recession. So we'll go back and look at 1982 and 1980. **[TC 12/8, p. 49]**

Participant C-12
I was going to say I like to look through a full cycle, and today that tends to work out to a decade or more. And unfortunately I end up looking at three to five years often because that's what I'm given, but if I look at three years for a really extensive credit exposure, I'm looking at one small leg of the cycle. And it's not enough. It's a mistake that I think a lot of people I work with and I fall into because we don't have more readily available. It's one area where I think Europeans do a better job than we do. A lot of European companies will routinely put a decade of results in the annual report, and you can see that development over a full cycle. [Also included in 2(d)] **[TC 12/8, p. 49]**

Participant C-4
One thing that we do look at is the term of the current management and focus on that, whatever that period may be. **[TC 12/8, p. 49]**

Committee/Staff/Observer
Question 12. What additional financial information do you regularly use that is not part of external reporting? How do you get that information, since by definition it isn't inside the normal package of information you receive? **[TC 12/8, p. 50]**

Participant C-14
The best thing that we get, quite often, is the bank agreements. The bank agreements often have the tightest covenant protection for the public creditor. Even though the bond holder is protected by the terms of the indenture, we usually find the bank is in control of the assets, in control of the equity, and it has the tightest restrictive covenants with regard to spending, capital expenditures, share repurchases, dividends. So quite often if the term of the bank agreement were longer than the debt instrument, the bank agreement would probably give you as much or more comfort with regard to controls on management and the way they run the business. Usually the bank agreements are shorter than the term of the debt, and so you're in a position where you've got an unprotected term of the bond you're rating out there. But we

think it's still very helpful to look at those bank agreements. It really tells you what the controls are on management. [Also included in 13] **[TC 12/8, p. 50]**

Participant C-5
The items that we are always looking for are projections of revenues and new products, particularly when they're rolling something out, or when they make a capex spending that's directed at a specific revenue target. We're looking back into historicals for as much as we can get, price-volume changes in revenues. And backlog is something we keep in mind. Backlog has proven to be fleeting in many cases, but it does give you a sense in evaluating this the potential success that a revenue stream and the realism associated with those projections. Everything is almost a reaction to the top line for management, and so the more we understand about the top line, the better off we are. [Also included in 12 and 13] **[TC 12/8, p. 50]**

Participant C-9
I second that one, and would add in the relationship between volume and cost structure. [Also included in 12 and 13] **[TC 12/8, p. 51]**

Participant C-7
The revenue side is where we start. Projected revenues, backlog comparisons from period to period to see the trends. [Also included in 12 and 13] **[TC 12/8, p. 51]**

Participant C-6
We're a big believer in interim information. We don't like surprises. Also monthly sales figures give you a pretty good feel for what's happening with the company month to month. Unfortunately too many times you do get surprised when you only get an annual financial statement. [Also included in 11(e)] **[TC 12/8, p. 51]**

Participant C-16
I'd like to understand how close formula based borrowers are to their covenants, to give me a sense for their borrowing capability and liquidity. [Also included in 13] **[TC 12/8, p. 51]**

Participant C-9
In evaluating a lot of financial institutions, a lot of the information is in management discussion, not necessarily in footnotes. So that's where I would be getting information on commercial real estate, asset quality, loan composition, liquidity. Average amounts of assets and liabilities is very helpful in many ways. Financial institution has dramatic flows during the day, what we're seeing typically is end of the day, and if you look at the average you can make some assumptions about potential window dressing. [Also included in 13] **[TC 12/8, p. 51]**

Participant C-10
On your list we've got backlog and I wrote "heavy" next to that, in other words heavy use, I put a big emphasis on that. Some companies don't have much backlog, it's almost a daily order business. It varies from company to company, and then sometimes by type of product line; one type of product line would have a heavy backlog because of its link to the construction nature, like your production contracts. That's a short term piece of information,

but very helpful to understand how your company is going, especially its liquidity. [Also included in 3(c) and 13] **[TC 12/8, p. 51-52]**

Committee/Staff/Observer
Do you track backlog as opposed to getting it once a year? [Also included in 13] **[TC 12/8, p. 52]**

Participant C-10
No. I ask about it all the time, and that's not a very formal measure. In other words, if I'm talking to the management that's one of the first questions I'll be asking to them routinely every month or every quarter. [Also included in 13] **[TC 12/8, p. 52]**

Committee/Staff/Observer
Is it normally just a verbal passage of information, as opposed to anything written down? [Also included in 13] **[TC 12/8, p. 52]**

Participant C-10
You also look in the 10-Q for it and other source of information that you have. But lots of times you can get a clue as to the company's current conditions by that type of question early on. [Also included in 13] **[TC 12/8, p. 52]**

Participant C-4
Backlog is the lifeline of a contractor, obviously. We can use that information to make some pretty accurate projections of where they're heading. We get backlog information on a quarterly basis, and we'll compare the beginning and ending gross margins, do a statistical correlation of those margins. Then when we get a year end financial statement, using percentage of completion basis and we'll adjust that cost to complete number based on historical correlation, and then make a projection of where we think this contractor is headed with the backlog he has on hand. So, it's vital information for us. I would say the accounting profession does not do that detail in general for smaller contractors in any audit work on the cost to complete for contractors. I think they're relying on what management tells them. I don't know how much hindsight review is actually going on in the accounting industry on cost to complete information. [Also included in 11(c), 13, and 17(a)] **[TC 12/8, p. 52-53]**

Participant C-11
I think there are many information items that are important to particular industries. If the purpose of the question is to say what kind of information should be important, I think the question really should be addressed in the context of specific industries? I think that on a more general basis, it certainly is helpful for me for a company to disclose broad goals, be they in terms of the kinds of businesses that they want to get into or get out of, the kind of capital structure they might want to establish in terms of debt or whatever ratios, dividend pay-out. That can be the most important thing; to let you know what management's goals are. [Also included in 13] **[TC 12/8, p. 53]**

Participant C-5
We do a commercial finance exam program for the company that typically is very revenue-sensitive. Part of that review is looking at the backlog, the order book, the cancellations, the seasonal performance. In some industries we do get regular reporting of backlog information. Others it's just a part of the routine sort of thrice annual commercial finance exam that would be conducted and we do verify to some degree that backlog. [Also included in 13] **[TC 12/8, p. 53]**

Participant C-10
We're starting to see more environmental claims involved in our different examinations of companies. And we're starting to spend more time trying to identify and understand it. It's still new. [Also included in 13] **[TC 12/8, p. 53]**

Committee/Staff/Observer
Let me launch just a second tier inquiry, then. Thinks like environmental, as opposed to backlog. I understand, I think, what you said about backlog, is that you just get in the company's face and you ask the question and in some cases you may get paperwork. Environmental--how do you get that information? [Also included in 13] **[TC 12/8, p. 53-54]**

Participant C-10
Footnotes. Sometimes it might be a lawyer involved, or there's a reserve. [Also included in 13] **[TC 12/8, p. 54]**

Participant C-1
A lot of times it's footnotes. Some companies have been more aggressive in putting reserves on for potential liabilities. It's something that is becoming more disclosed. We ask questions like: how big is the potential litigation list for companies getting sued? Any type of class action lawsuits? Etc. Usually what sparks you to ask questions is the prospectus, which will have more of that detailed, which then leads you to be able to ask the question well, what's the status on that? Companies are very loathe to disclose potential liabilities, obviously, and I don't think you're ever going to get that disclosed in financial statements. [Also included in 13] **[TC 12/8, p. 54]**

Committee/Staff/Observer
You were drawing a line for us earlier about the insider line where you say you don't want to cross it, because obviously then it hampers your ability to do anything with respect to that company. Does this need to know more about litigation get close to that line? [Also included in 1(d)] **[TC 12/8, p. 54]**

Participant C-1
It gets very close. I mean you don't need to know about all litigation. For example, we have a company that closed a subsidiary and the employees are suing. It's a class action lawsuit by 2,000 out of work blue collared employees. It's going to go on for years. That's the type of thing where we need to know and ask question about. I think crossing the line is knowing the risk is $100 million, and most companies won't tell you that. [Also included in 1(d)] **[TC 12/8, p. 54]**

Participant C-13
The key to the inside information question is the materiality question. And so where you cross the line is where it becomes material. Unless the information that you're getting about the lawsuit is such that it would trigger an investment action, then it's not material. [Also included in 1(d)] **[TC 12/8, p. 55]**

Participant C-5
Doesn't disclosure in effect move the line, though? I mean as this is disclosed, it becomes public information. [Also included in 1(d)] **[TC 12/8, p. 55]**

Participant C-13
Sure, if you get a piece of material information in a management interview, you tell them to disclose it. [Also included in 1(d)] **[TC 12/8, p. 55]**

Participant C-1
The real issue that we've got is that we have to constantly wrestle with wanting more public information, where you (banks) can go in and ask someone for that information. And they know it's never going to go any further anyway. For us it's more of an issue. [Also included in 1(d)] **[TC 12/8, p. 55]**

Participant C-5
From a bank credit standpoint, when it comes to valuation of collateral and fall-back, we don't wait for the accountants to tell us, we do our own environmental audits and inspections. By the time the disclosures would come out in any kind of financial reports, at that point we're dealing three months later, it's outdated information. **[TC 12/8, p. 55]**

Participant C-3
[Participant C-1], in the area of contingent liabilities, especially environmental, are you suggesting that the current FAS 5 rules aren't being followed, or aren't stringent enough? [Also included in 2(d)] **[TC 12/8, p. 55]**

Participant C-1
For example, I've got a company that's in a superfund site with a very impoverished little city, and the reality is the company is going to have to end up even picking up their costs. And the number is just really not disclosed anyplace. [Also included in 2(d)] **[TC 12/8, p. 56]**

Participant C-3
The reason I asked that question is this is an area where you currently have some accounting rules that govern not only the accounting but the disclosure, which is kind of different from some of the other issues that we've been talking about where there aren't any rules or any requirements. I'm not sure if this is an audit issue, or an SEC issue for a public company. [Also included in 2(d) and 17(a)] **[TC 12/8, p. 56]**

Participant C-11
It's judgment, isn't it? So it's a question of not just the management but the auditors having to make a judgment as to materiality, and being pro-disclosure. And oftentimes people aren't pro-disclosure if it's bad. So it's a problem. [Also included in 2(d) and 17(a)] **[TC 12/8, p. 56]**

Committee/Staff/Observer
Question 13. In what circumstances are creditors or credit analysts able to compel information to be produced? And among other things, we're trying to get a feel for whether or not the situation is always, never, or somewhere in between that you can compel this information. **[TC 12/8, p. 56]**

Participant C-2
If the borrowing is very significant to the company and there is not a lot of competition to make the loan, then you can generally get anything and everything you ask for. Then at the time of new borrowing or refinancing also you can usually get what you need, unless you're in a very competitive situation, and then less. When you're in a distressed situation, that varies from "you can get it with difficulty" to "you can never get it". If you're working with a troubled borrower and the relationship is over, then that's when we would like it to be compelled so that it's readily available. **[TC 12/8, p. 56]**

Committee/Staff/Observer
It draws an interesting curve. When it's first not really necessary borrowing, it may be difficult to get the information. As it becomes more necessary, it's more easy until it can't be repaid, and then it's not necessary anymore. **[TC 12/8, p. 57]**

Participant C-7
[Participant C-2] covered it. Basically situations two, three, and four (on page 13 of meeting materials) are the typical cases for a bank credit grantor. The money buys the information. **[TC 12/8, p. 57]**

Participant C-13
Obviously it's somewhere in between always and never for everybody. But there is a widespread myth that large investors have the market power to force companies to disclose. I've had this expressed to me by regulators, by legislators, and others. We can't do that. Not only do they hide behind the 300 holder rule that [participant C-10] mentioned, but it is not possible in every circumstance to compel companies to disclose the information that we need. **[TC 12/8, p. 57]**

Participant C-1
There is also an incentive, especially in the high yield area, not to disclose anything, because you want the value of the securities to decline so that you're able to repurchase them. And the only time you get significant information is when they want your money, and once they have it, you don't get anything. I think there is also a difference between the amount of information that's provided in a prospectus and the amount of information that you get on an ongoing basis. [Also included in 2(a)] **[TC 12/8, p. 57]**

Participant C-14
For anyone who may not believe that, we actually have companies in that situation that tell us they don't want upgrades in rating. **[TC 12/8, p. 57]**

Participant C-5
There is a lot of compelling that we can do, but at some point you reach a point where you realize they don't have this quality of information. We're the only one asking for it. And it's not even a competition factor at this point, it's the preparation of the material. For example, some of the segment reporting; I mean they're lucky to get a balance sheet and income statement together, let alone segment reporting. It's not necessarily a matter of resisting or fighting or feeling they're so powerful in the relationship that they can tell us what we're allowed to have. It's really just lack of that understanding of the information. [Also included in 3(a)] **[TC 12/8, p. 58]**

Participant C-4
I think one of our objectives for which we need financial reporting is to determine whether or not we're going to continue to extend credit. I think our needs are also to assess our liability as a result of our extending credit. And a lot of times when we're in a distressed situation, information is not available. If the accounting reports were more standardized with some more information that's pertinent to us, then we wouldn't have to go through the process of trying to solicit information that management won't provide to us. [Also included in 2(a)] **[TC 12/8, p. 58]**

Participant C-1
I think in a way both these comments refer to an issue that we all wrestle with, which is the quality of financial statements. In no place in the financial statements there is a ranking of the quality of the information which management and accountants rely upon in order to generate the financial statements. [Also included in 2(d)] **[TC 12/8, p. 58]**

Participant C-6
That's a very good point. We've run into a couple of situations where we've asked for information that we weren't able to obtain because management wasn't able to put it together for us. That was a very telling sign as far as management information systems in place and management itself. [Also included in 2(d)] **[TC 12/8, p. 58]**

Participant C-10
When you get on a bankruptcy committee, you can compel information. But the company is paying for it at that point, and in effect the lender is starting to become the equity holder. There is a cost that the company at that point has to incur. [Also included in 2(d)] **[TC 12/8, p. 59]**

Participant C-6
Dealing with private companies, typically the information that we'll ask for in an initial contact is three to five years of annual statements; a current interim statement if available,

some trade references, some copies of some current bank statements, and personal financial statements. That will typically get us started, and then we go into analyzing the numbers, and going into some ratio analysis and looking at cash flow, and looking at personal financial statements, looking at personal assets of the owners, and so on. [Also included in 1(c)] **[TC 12/8, p. 60]**

Participant C-5
I don't agree with providing projections in the public financials and with auditors contributing to those in a published financial statement, even for a private company. We do get projections, we wouldn't do any term finance without projections. Any credit greater than a year, we require projections. We do a separate bank case which is our own assessment of that and which is much more a downside analysis. What we do use them for are two key purposes. One is management is forced to reconcile their ability to do certain things in the future such as capital expenditures. We don't have to worry about two years from now management coming back and in and wanting to discuss a dramatic new capital expenditure program, because we've had an adequate discussion of those items well in advance of that. A second item and what we really do use management projections for is we tie our fences right off of that. Every covenant is tied just off of management numbers. So whether they want to be optimistic and rosy and put a 25% sales growth in there, we'll be just under them at 24% with our hurdle. And when they come back in, we'll charge them default rate pricing until you get that corrected. Projections are a valuable tool, and we wouldn't ignore them, but we would end up discounting them just like we discount managements' projections if they came from an auditor and would be part of the financial package. It would add to cost, it wouldn't add to value, necessarily. There are pieces of current historical information with more detail that would allow us to make our own judgments about those projections which are not adequately disclosed, like capital expenditures. That's what we need to do our analysis better. [Also included in 1(c), 12, and 17(b)] **[TC 12/8, p. 71-72]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 2

At the meeting, we discussed the purpose of external reporting and some related accounting propositions. Most of our discussion related to the propositions. Please indicate your agreement or disagreement with the following with respect to the overall purpose of external reporting:

	AGREE	DISAGREE
a. Creditors are concerned whether a company will have enough cash to repay its obligations when due. The sources of that cash include (1) operations, (2) future borrowing, and (3), if necessary, realization of collateral. Thus the primary purpose of external reporting is to help creditors assess the adequacy of the amounts and timing and the uncertainty of the company's future cash flows from those sources.	14	3

If DISAGREE, please explain:

Participant C-3 - Sales of assets should be included as a source. It's important to assess not only the existence of saleable assets, but also the company's ability to consummate the sale, given current market conditions.

Participant C-4- AGREE - Primary focus on cash that can be generated from operations or reserves in the balance sheet.

Participant C-18- Again, do not agree that financial statements are useful in assessing collateral values. Also, financial statements should assist creditors in assessing financial flexibility (the ability to shift in/out of activities as profit opportunities change over time).

Participant C-11 - AGREE *BUT* - Primary purpose of external reporting is to provide data which, along with other information and knowledge, will help creditors assess. The accounting information above is not sufficient by itself.

Participant C-9 - Too narrow. While ability to pay is the ultimate concern, analysis of banks' ongoing credit worthiness as regards to fixed income securities values is less "mechanical" and doesn't employ a full cash flow analysis. Rather, one assesses major profitability risks/benefits. Arguably, the fungibility of financial companies may underlie the difference. Primary needs are: asset quality information, capital ratio compliance and liquidity.

Participant C-16 - Other source could be equity offering, sale of assets.

Participant C-19- Most helpful when the direct method is used in presenting the statement of cash flows.

Participant C-13 - This statement, of course, pertains to the creditors' concerns, not those of other parties.

	AGREE	DISAGREE
b. As a means of assessing the adequacy of future cash flows, accrual-based information in balance sheets provides useful information about:		
•The quality of assets that are sources of future cash flows (in this context, quality means risks and uncertainties of future cash flows derived from those assets)	12	4
•The liquidity of the borrower	12	4
•The types and amounts of assets that may be available to secure or repay a borrowing	13	3

If DISAGREE, please explain:

Participant C-3 - I don't think historical cost is a useful measure in assessing the ability of assets to secure or repay a borrowing. Ultimately, the lender has to assess the market value (or fair value, if no market).

Participant C-15- AGREE - I think that there should be more emphasis on earnings from continuing operations and cash flow from operations. The sale of assets or securitizing assets are a last resort for cash flow in industrial entities only after there is a deficiency in cash flow from operations.

Participant C-10- Accrual based accounting is only 10% of the information needed. Cash flow is much more important = 90%. For instance - statement A on Question 2 (1) operations is much more important than (3) realization of collateral. Also, liquidity of borrower is tough to ascertain and accrual statements do not provide much help on this.

Participant C-7 - Financial statements utilize historical cost as opposed to liquidation values because of the going concern thesis.

Participant C-12 - It is the job of the user of financial statements to determine the quality of assets, based on data concerning risks and uncertainties provided (in part) by the prepared financial statements.

Participant C-4 - Accrual liability billings in excess of costs and earnings does not provide useful information about liquidity. In the example below, percentage of completion accounting would show a $100,000 balance sheet liability for a job with $50,000 of positive

future cash flow. In this instance, accrual accounting does not reflect the liquidity of an entity.

Example: Job A	
Contract price	\$1,000,000
Billed to date	600,000
Cost to date	350,000
Est. total cost	700,000
Percent complete	50%

% calculation - 50% x 1,000,000 = 500,000 Rev. Earned
\$100,000 Billings in excess of cost and earnings

Accrual Accounting		
Actual job cash flow →	Remaining to bill	\$400,000
Cost to complete		350,000
Future Cash Flow		\$ 50,000

Participant C-11 - These don't necessarily follow from accrual accounting.

Participant C-16 - Regarding the third bullet: Together with borrowers' inherent financial strength, *e.g.*, ability to borrow without pledge of collateral.

	AGREE	**DISAGREE**
c. Accrual-based earnings statements and statements of cash transactions are both important to creditors, with the relative importance dependent upon the individual borrower's circumstances and industry.	**13**	**4**

If DISAGREE, please explain:

Participant C-10 - The relative importance depends upon the creditor methods of evaluating the borrowers' cash flows and their potential sources.

Participant C-12 - The relative importance probably depends most on how different the cash flow statements are from accrual statements. A second reason why cash flow statements will be viewed as less important is weakness in their presentation, *e.g.*, how rollover of short-term borrowings is handled, which affects certain industries, *e.g.*, banking, more than others.

Participant C-4 - Agree with first half of the statement, but degree of importance is insignificant because cash flow, either short-term or long-term, is of equal importance to all owners and creditors. Dividends, interest and principal repayment are made in cash, not from accrued net income!

Participant C-18 - Agree with first half. Disagree with second half. In all situations/circumstances, both accrual and cash earnings statements are equally important.

Participant C-11 - Agree *BUT* - (add after "industry") . . . and the particular matter under analysis.

Participant C-2 - Statements must be used together to understand differences between cash and accrual cycles.

	AGREE	DISAGREE
d. Comparisons of accrual and cash transactions information for the same periods over time provide a crosscheck of the trends of (1) historical earnings and (2) historical cash flows as *reliable indicators of future cash flows*	12	5

If DISAGREE, please explain:

Participant C-3 - Not always. Other factors should be considered (industry/competitive trends, quality of assets, etc.) that could make the future different from the past.

Participant C-7 - Not in and of themselves. Historical earnings and cash flows are used to check the borrower's projections of future income and cash flows for reasonableness.

Participant C-18- I have no idea what "crosschecks" implies here. The value of comparisons is that they shed light on the underlying dynamics shaping a firm's financial flows. If that's what you mean, then I agree.

Participant C-11 - The historical data alone do not provide reliable indication of future cash flows.

Participant C-2 - *Changed the period after "flows" to a comma and added:* adjusted as appropriate for management's objectives and/or representations regarding future events.

Participant C-13 - These comparisons provide useful information about the relative trends of the items in the past and can be a guide to their possible future trends, but are not necessarily reliable future indicators, which depend on numerous other factors.

	AGREE	DISAGREE
e. Non-cash charges (*e.g.*, charges for which there will be no future cash flow) to accrual-based earnings also are informative about asset quality and trends, and, thus, are useful in assessing future cash flows.	15	1

If DISAGREE please explain:

Participant C-10 - AGREE - This is very important and should be highlighted in footnotes.

Participant C-4 - Certain noncash charges in no way assist in assessing future cash flow. Example: % of completion accounting - Current liability - Billings in excess of costs and earnings (Question 2b response).

Participant C-18- AGREE - Absolutely! Noncash charges are true costs (only difference is timing). Creditors must be able to assess prospects for continued economic viability; hence, total revenue/cost trends are important data.

Participant C-11 - Sometimes - depends on the nature of the charges.

Participant C-2- Important information to factor in analysis of past and current earnings and cash flow, as well.

f. My credit analysis normally includes isolation of the following amounts:

i. Core accrual-basis earnings		15		**2-Sometimes**
ii. Core cash flow from operations	15		2	

[PMQC 12/8, p. 2-7]

QUESTION 4

During the meeting, references were made to the need to identify "core earnings" and to problems of "complexity" in accrual earnings information. Below are listed several types of information that can potentially be used to adjust reported earnings obtain to "core earnings".

Please indicate for each:

Yes - If you normally adjust earnings for the item
No - If you normally do <u>not</u> adjust earnings for this item

Reasons for adjustment	**C** -	To adjust an earnings items to a **cash flow**
(more than one	**E** -	To eliminate **complexity**
may apply)	**U** -	To adjust for **unusual items** not considered part of the core

	<u>Adjust</u>	<u>Reasons</u>
a. Discontinued Operations	16	14-U, 4,C, 1-E
b. Items labelled Extraordinary	15	12-U, 4-C
c. Items included in "Other Income/Expense"	5	5-U, 1-C

d.	Items identified by management as unusual	12	11-U, 2-C
e.	Expenses (losses) accrual for litigation/ environmental obligations	11	9-U, 3-C
f.	New businesses acquired	5	1-U, 2-C, 1-E
g.	New products	1	
h.	Capital expenditures	3	2-U, 1-C
i.	Changes in management's objectives	4	1-C, 1-P
j.	Changes in management's strategies	3	1-C, 1-P
k.	Changes in capital structure	3	1-C, 1-E
l.	Expenses accrued for Pension/Profit sharing plans	6	6-U, 1-C
m.	Deferred income taxes	4	2-U, 2-C
n.	Operating profits of continuing segments	1	1-U
o.	Expectations about industry trends	3	1-U, 1-E, 1-P, 1-F
p.	Expectations about general economic trends	3	1-U, 1-E, 1-P, 1-F
q.	Stock options or stock award plans	3	2-U, 1-C
r.	Expected interest rate changes	3	1-C, 1-E, 1-P, 1-F
s.	Goodwill amortization	10	3-C, 7-C
t.	Depreciation expense	8	2-U, 6-C
u.	Increases in collection loss reserves	4	2-U, 2-C
v.	Share of earnings of affiliates	8	2-U, 5-C, 1-E
w.	Gains or losses on investment securities	10	10-U
x.	Gains or losses on sales of productive assets	13	12-U, 1-C
y.	Writedowns (impairment) of assets	14	13-U, 1-C
z.	Costs of restructuring	13	9-U, 1-C, 1-E

Participant C-3 - Under Reasons for adjustment he added: F - To consider the effect that the past might not be indicative of the future. *Under item h:* N/A - banks are not capital intensive. *Under items i,j and k:* I wouldn't adjust earnings for these factors. Instead, I would let the numbers "stand alone" as support for a potential change in objectives, strategies, etc. *Added before item w:* Unusually large. . .

Participant C-15 - Under items b, d and u: Depends on items. *Under items i and j:* No accounting reason. *Under items o,p and q:* Audit forecasts. *Under items y and z:* If extraordinary.

Participant C-12 - Under item m: No one understands tax accounting. *Under items u and y:* In analyzing a bank, I try to isolate two separate earnings parts: earnings before losses, and loan loss expenses.

Participant C-5 - Under item g: Comparable sales. *Under items i and j:* Proforma impacts. *Under item m:* Likely future cash.

Participant C-11 - U = I choose what is unusual and don't rely on management's or accountants' classifications.

Participant C-9 - Under Reasons for adjustment he added: P - Predict earnings. *Under item d:* Depends on nature. *Under items i and j:* Quantify.

Participant C-2 - Under item d: Maybe - Depends on situation C and ?. *Under items f and g:* But will try to segment these from previous operations to judge impact on earnings and cash flow. *Under items h, s, t, u, w and x:* No but C applies. *Under items o and p:* But incorporate into projections. *Under items u:* Warning sign.

Participant C-13 - Under items a, b, c and d: Subject to analysis as to whether item is genuinely "unusual," etc. *Under item e:* Unless particularly significant.

[PMQC 12/8, p. 10-12]

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement. During the discussion, comments were made on the types of information creditors use to achieve their objectives.

Committee/Staff/Observer
And it would be safe for me to leave today with an understanding that maybe your needs with respect to middle market smaller organizations might be different than they would be in a Fortune 500? For the former focus is on perhaps the quality of the underlying assets and perhaps with the latter it's the quality of the underlying control systems and environments, and those kinds of things; is that a fair thing for me to walk away with? [Also included in 5(b) and 17(b)] **[TC 3/11, p. 15]**

Participant C-1
I don't know if I agree with that at all. Some of the companies that we lent to, that are high-yield companies, are in the Fortune 500. And I think what we're concerned about is the quality of the inventory and the quality of the receivables. If we're lending to a company that the inventory is good for all time to come, fine, but I can't tell you the number of times we've lent money to a company and all of a sudden 20% of their inventory, while it's still good and could be sold, might take ten years to sell it, because no one wants it. And it's been sitting there forever and it's not a current asset, it's really a long term asset. Or, with [name deleted], how many parts do they have that go for a 1980 model that are still sitting in inventory, that really are not going to be liquidated, or not going to be used for the next year; it really is a long-term asset? That's where I become more concerned. You know we're all concerned about environmental problems, and pension problems, and legal liabilities, but the concept that inventory is always a current asset, as we're all trained and taught in business school and undergraduate, just isn't true anymore. [Also included in 5(b) and 17(b)] **[TC 3/11, p. 15]**

Participant C-12
I probably get as much, looking at financial institutions, information out of the MD&A as I do out of the balance sheet and income statement and footnotes. Therefore, it would be very important to me to know that I can have as much comfort and faith in those numbers because I do get as many numbers out of the MD&A as I do anywhere else. If I had to pick one thing in expanding the auditor's role, that would be it. [Also included in 13 and 17(b)] **[TC 3/11, p. 22]**

[Context] The paper is a summary of a committee and staff members' discussions with selected sell-side analysts from Bear Stearns.

"Morning Call" is a meeting (usually via a conference call) between the Bear, Stearns analysts and the sales force where the analysts communicate the results of recent research (and a strong, buy, hold, or sell recommendation) and the expected impact on securities of recent information (e.g., press releases, meetings with analysts, changes in interest rates, economic outlook, and other market factors). [Also included in 1(a)] **[BEAR STEARNS, p. 1]**

Items mentioned during the analyst reports on the morning call were as follows . . . :
- Oil reserve increases resulting from recent drilling activities
- Sales trends, profit margin trends, sales by product line
- Gross margin trends
- Impact on tax rate resulting from nondeductible goodwill
- Foreign currency benefits
- Core business trends and focus markets
- Earnings momentum
- Leading indicators for a particular company and/or industry.

[Also included in 1(a)] **[BEAR STEARNS, p. 1]**

[One analyst] expressed the following . . . regarding his approach to securities analysis: [Also included in 1(a), 2(c), and 15] **[BEAR STEARNS, p. 1]**

- It is critical that there be consistency in the application of accounting principles, not only for purposes of comparing a company's performance over a period of time, but in comparing a company against other companies in the same industry. For example, the flexibility provided by FASB Statement No. 86 (software costs) allows flexibility in determining the point at which software product development costs should begin to be capitalized. Depending upon the company's approach to software development, a relatively large portion or relatively small portion of software development costs can be capitalized, resulting in diminished comparability between software companies. (He would prefer that companies expense all software development costs.) [Also included in 2(c) and 15] **[BEAR STEARNS, p. 1-2]**

- He believes that there should be greater clarity in financial reporting and would like to receive the following as part of general purpose financial reports:
  - More detailed information on a company's international operations.
  - Disclosure of sales/margins by product line and plans for future shipments.
  - Historical data compared to management's goals.
  - Revenue breakdown by product on a quarterly basis.
  - Better disclosure of foreign currency effects on the financial statements.
  - Separate disclosure of depreciation vs. amortization expense amounts in order to better analyze changes and trends in the related asset accounts.
  - A table that shows scheduled depreciation charges for each of the next five years and thereafter (similar to a lease commitment table).

[Also included in 15] **[BEAR STEARNS, p. 2]**

- [H]e looks at the pension disclosures to identify the funded status of the plan, but does not perform further analysis on pensions. In addition, he does not perform detailed analysis of the lease commitments that are disclosed in the financial statements. **[BEAR STEARNS, p. 2]**

To improve financial reporting, from an analyst's point of view, [one analyst] recommended . . . the following. . .: [Also included in 2(c), 3(a), 8(d), 15, and 17(d)] **[BEAR STEARNS, p. 2]**

Include disaggregated disclosures by operating unit that would show revenues and operating income, cash flows and relative returns for each operating unit. [Also included in 3(a) and 15] **[BEAR STEARNS, p. 2]**

[Context] A company provided information on the following in a conference call with analysts from several analysts' firms:

- Product and geographic sales mix
- Depreciation amounts by segment
- Monthly profit (loss) (trends for the most recent quarter)
- Price increases by segment
- Projected gross margins
- Prospects for changes in employee headcount
- Inventory levels at the distributors
- Trends in the levels of orders received
- Availability of supplies
- Historical and projected depreciation and capital expenditures
- Separate disclosure of amounts for depreciation and amortization.

[BEAR STEARNS, p. 3]

[One analyst commented on the] following regarding her approach to securities analysis and financial reporting in general: [Also included in 1(a), 5(c), 6, and 15] **[BEAR STEARNS, p. 3]**

- It would be helpful if nonhomogeneous (e.g., finance) subsidiaries were disaggregated from the consolidated financial statements. [Also included in 6 and 15] **[BEAR STEARNS, p. 3]**

- Prefers the indirect method of presenting the statement of cash flows. (She does not use the condensed cash flow statement that is provided in the Form 10-Qs and believes that it could be eliminated.) [Also included in 5(c)] **[BEAR STEARNS, p. 3]**

For the [CIC] Diversified Companies Subcommittee, the basic necessities in corporate publications were:

- A statement of corporate goals.
- A fact book.
- Inclusion of the ages and length of service of directors, and executive officers.
- More complete financial highlights.
- A ten-year financial history.
- Transcripts of question and answer periods at meetings, particularly meetings for financial analysts.
- Detailed breakdowns of segment operations in quarterly shareholder reports.

[AIMR/CIC90, p. 2]

The subcommittee defined its "perfect" quarterly report as including, but not be limited to, the following: balance sheet, income statement, contribution to revenues and operating income by segment, cash flow statement, and detailed commentary. A section called "Outlook" would be helpful.
[AIMR/CIC90, p. 2]

The [CIC] Computer and Electronics Subcommittee noted numerous instances in which companies could better define the earnings impact from currency fluctuations, again reflecting the growing importance of international operations. **[AIMR/CIC92, p. 1]**

Most [CIC] subcommittees agree . . . [that] the following suggestion seems appropriate: [Also included in 2(b), 2(c), 3(b), 3(d), 5(a), 5(d), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3]**

- A factbook that provides considerable major background data and preferably a ten-year financial and operating history. [Also included in 1(b) and 13] **[AIMR/CIC92, p. 3]**

- Segmented financial and operating data, particularly on a quarterly basis, where appropriate both by lines of business and geographic. [Also included in 3(b), 1(b) and 3(d)] **[AIMR/CIC92, p. 3]**

- Quarterly reports with timely data presented in a format comparable to that of the annual report. [Also included in 1(b), 2(b), 2(c), and 11(a)] **[AIMR/CIC92, p. 3]**

- Reports should be prepared under a standard format. Companies that use the metric system should provide appropriate tables for conversion, while companies seeking foreign investors should state appropriate currency exchanges rates. [Also included in 1(b) and 16(b)]
[AIMR/CIC92, p. 3 and 4]

- Segregation of the financial impact from nonrecurring items (asset sales, write-offs, etc). [Also included in 1(b) and 5(a)] **[AIMR/CIC92, p. 4]**

- Prompt communication of significant developments. This includes major changes in strategy as well as business conditions. This would also include full disclosure of the anticipated financial impact from new accounting principals: FAS 107 (Fair Value), FAS 106 (Retiree Health Care), FAS 109 (Income Taxes). [Also included in 1(b), 5(d), and 13)] **[AIMR/CIC92,
p. 4]**

- The investor relations effort is most important and should be handled by someone who is accessible, well informed and empowered to discuss important matters with little restraint. [Also included in 1(b)) **[AIMR/CIC92, p. 4]**

[The CIC has] cited numerous examples of disclosure formats that were particularly useful and insightful. More than one subcommittee, for example, pointed out the utility in trends analysis of having 11 years of historical data made available in a table in the annual report. Still others noted the growing value of factbooks, many of which provide additional layers of detail, not only about a particular company's operations but also about the industry in which the company operates and the broader economic climate as well. [Also included in 5(d) and 13] **[AIMR/CIC92, p. 4]**

[An] example [by the Georgia-Pacific Corporation] of . . . disclosure that address[es] one the most important needs of the investor; concise and complete segment information. In its 1991 annual report to shareholders, Georgia-Pacific Corporation presented a breakout of sales and operating profit in 13 different forest product sectors. The breakout not only provides current year numbers but also equivalent data for each of the preceding ten years. [Also included in 3(c)] **[AIMR/CIC92, p. 4]**

In some cases financial data have been destroyed without commensurate improvement in the financial information provided. Financial analysts generally do not rely on a single year's results to make their decisions. They typically gather information for a long period of time and analyze trends and relationships. (Five years of historical data is common; ten years is preferred. Recognizing the importance of understanding corporate results over more than one business cycle, AIMR's Corporate Information Committee, which annually evaluates the status

of corporate reporting, encourages eleven-year financial histories. Some industry subcommittees provide bonus points for twenty-years of historical data.) [Also included in 2(c)] **[AIMR/FAF91, p. 9-10]**

A change in accounting principles destroys the comparability of data before and after the change. Even when the FASB requires restatement it provides analysts with only three comparable income statements and two comparable balance sheets. Occasionally, analysts have sufficient information to estimate the impact on earlier years and are able to restate the results themselves. Some companies take the time to assist analysts to understand the pre- and post-change data. Generally, the ability to analyze trends over a long period is simply destroyed. [Also included in 2(c)] **[AIMR/FAF91, p. 10]**

Objective 2 [Keep standards current to reflect changes in methods of doing business and changes in the economic environment]... Overall we believe that the FASB has attempted to keep standards current to reflect changes in methods of doing business and changes in the economic environment. There are some notable exceptions, however. **[AIMR/FAF91, p. 15]**

FAS No. 87 (Pensions) was being developed during the early part of the 1980s, when the full dimension of the decade's mergers and acquisitions activity were not clear. Experience following promulgation of FAS 87 showed that the failure to provide adequate disclosure of the effects of mergers, acquisitions, and divestitures often makes it impossible to use the required information sensibly in analysis. The statement should be amended to provide such disclosure. **[AIMR/FAF91, p. 15-16]**

Users of financial statements have long urged regulators and standard-setters to require, at a minimum, disclosure of off-balance sheet financing so that a reasonably accurate estimation can be reached about the liquidity and credit worthiness of entities. The complexity of the issue, its rapidly changing dimensions, and a combination of preparer reluctance and a lack of accounting experience have delayed the communication of much needed information into the market. FAS No. 105 (Disclosure about Financial Instruments with Off-Balance Sheet Risk and Concentrations of Credit Risk) is a belated but good beginning. **[AIMR/FAF91, p. 16]**

[Background] *The Financial Industry--Banks, Thrifts, Insurance Companies, and Securities Firms* is the second in a series of AIMR Industry Analysis seminars and proceedings. The series was conceived by Charles D. Ellis, CFA, to provide educational material on the nuances of individual industries from the perspective of security analysis. . . . Each seminar is built around an analytical framework that identifies the key factors to consider in conducting an effective analysis of the industry and that highlights the specific interrelationships that underlie sound valuation decisions. . . . The speakers at the seminar, whose presentations this proceedings reproduces in full, are among the leading specialists in financial services industry analysis. **[AIMR FINSER INDUSTRY, p. i]**

[For the banking industry,] once usable and appropriate data are generated, valid peer comparisons are possible, and Nagle[1] says the most useful peer group comparisons are market indicators, profitability measures, net interest margin, operating efficiency, noninterest revenue, capitalization, asset quality, and asset composition. He applies this concept by comparing the relative attractiveness of a regional bank not only with its peers in the area but also with all banks of like size and with the median for all national banks. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 2-3]**

In selecting bank stocks to structure a portfolio, Schmidt[2] uses a process that first evaluates the national economy and then looks into regional factors, including business growth prospects and the regulatory environment. Within the national overview, emphasis is on the economic growth outlook and on the interest rate forecast. Schmidt argues that banks are related to the economy, but only in one direction--down. A healthy economy can mean higher bank earnings, but a bad economy, or a weak segment within the economy, will cause poor profits. Comparisons indicate that absolute bank stock performance is inversely related to interest rates, but taken relative to the S&P 500, the correlation between bank stock prices and interest rates disappears. This suggests that the correlation is a market effect. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 3]**

Important regional factors in the valuation model are growth prospects, asset values and credit quality, and the banking environment. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 3]**

In analyzing loan portfolios for banks and thrifts, Pringle[3] suggests examining category definitions and exactly what types of loans are included in each category, geographical and industry exposures, and the 10 largest credits. He then discusses analytical approaches in evaluating the loan portfolio. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 3]**

Pringle observes that an analysis of nonperforming assets is applicable both to banks and to thrifts. This analysis should focus on nonaccrual loans, renegotiated loans, 90-day past due and accruing loans, and other real estate owned. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 3]**

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[1] Reid Nagle, President, SNL Securities

[2] James K. Schmidt, CFA, Managing Director and Chief Investment Strategist, Freedom Capital Management

[3] David N. Pringle, Managing Director, Furman Selz Mager Dietz & Birney, Inc.

Seifer[4] identifies a number of issues that are basic to understanding past trends and possible future developments in the insurance business. Evaluation of the investment portfolio and cash flow provides an important financial health measure of the organization. Companies are attempting to emphasize portfolio liquidity and quality for the benefit of policyholders and stockholders, and those firms with positive cash flow are in a position to reduce problem assets as a percentage of total assets. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 4]**

Seifer says reserves are the most important factor in the analysis of an insurance company and pleads with the companies for more complete data on their reserve status. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 4]**

Frinquelli[5] states that the primary internal factors affecting valuation of insurance stocks are competition, volume, surplus and return management, and loss reserve policies. For property/casualty companies, product, geography, and distribution also are important considerations. **[AIMR FINSER INDUSTRY, p. 4]**

Managements have considerable apparent flexibility in creating and maintaining reserves, and changes in reserves can have a significant impact on the true value of a company. **[AIMR FINSER INDUSTRY, p. 4]**

The common belief is that all an analyst needs to know about the external factors that affect insurance stock prices is this: premium rates up, stock price up; interest rates down, stock price up. Frinquelli explains that there is much more to know, including the effect of changing interest rates on the balance sheet, the income statement, and ultimately on the trend in book value. Also, inflation must be considered, because liabilities are cost-based, not dollar-based. Inflation also is a vital element to be considered in analyzing medical care lines. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 4]**

Additional external factors Frinquelli considers are catastrophes, particularly their size, number, and type; regulation, including the possibility of an eventual federal layer of supervision; the extent of product diversification; the matter of asset quality; changes in demographics; and the impact of consumerism, as evidenced by the passage of California's Proposition 103 in 1988. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 4]**

[W]hen paid losses rise faster than earned premiums, the fundamental profitability of the company is under pressure; in some cases, substantial increases in reserves are signals of potential problems; and as in other financial businesses, cost control is getting increased attention. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 5]**

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[4] David Seifer, CFA, Vice President, Equity Research, Donaldson, Lufkin & Jenrette Securities, Inc.

[5] A. Michael Frinquelli, CFA, Managing Director, Salomon Brothers, Inc.

Three factors are cited as determinants of investment results, namely cash flow, interest rates, and investment policy. Cope[6] adds that many people believe cash flow is the key in trying to time the underwriting cycle: When cash flow turns negative for enough companies or for the industry as a whole, better pricing is in the offing. In fact, however, many companies now are experiencing cash flow squeezes or even negative cash flow, thus far without any effect on industry pricing. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 5]**

[According to] Zerbarini,[7] [t]he key ratios most analysts use in evaluating insurance stocks are price-earnings ratios, price-book-value ratios, and dividend yield. Zerbarini warns that the components of these ratios and thus the quality of both must be carefully appraised to avoid wrong conclusions about value. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 5]**

According to Liss,[8] industry fundamentals may not make brokerage stocks particularly attractive investments over the long term, but in the short run, they present significant moneymaking opportunities. He offers five key elements to consider in the valuation of brokerage stocks: fundamentals; technical factors; emotional factors; business segment appraisal; and retail, discount, and institutional considerations. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 6]**

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[6] Anthony T. Cope, CFA, Senior Vice President and Partner, Wellington Management Company

[7] Donald G. Zerbarini, Analyst, Lord, Abbett & Company

[8] Samuel G. Liss, Director, U.S. Research, Salomon Brothers, Inc.

[According to Nagle, for banks,] the most useful peer group comparisons are market indicators, profitability measures, net interest margin, operating efficiency, noninterest revenue, capitalization, asset quality, and asset composition. **[AIMR FINSER INDUSTRY, p. 31]**

[According to Schmidt, they] have developed a process [they] use to select bank stocks and structure a portfolio. The process involves first understanding what is going on in the national economy. Then, [they] look into regional factors--economic growth prospects and the competitive and regulatory environment for banking. [They] then develop and maintain a model portfolio. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 42]**

The national overview has two important aspects: the economic growth outlook and the interest rate forecast. The first step is to determine where the economy is going. Banks are related to the economy, but only in one direction--down. A healthy economy can mean bank earnings are up somewhat, perhaps 8 or 10 percent, but a bad economy or a weak segment within the economy can cause disaster. **[AIMR FINSER INDUSTRY, p. 42]**

The second macro factor is interest rates, and both the basic direction of interest rates and the spreads are important for banks. **[AIMR FINSER INDUSTRY, p. 42]**

Because the banking system is fractionalized, the characteristics of different regions of the country are an important consideration. Three characteristics are particularly important: growth prospects, asset values and credit quality, and the banking environment. **[AIMR FINSER INDUSTRY, p. 43]**

The economic growth of a region as measured by growth of employment or payroll is important because it forms a foundation for balance sheet growth. Simplistically, growth in bank earnings is a function of the growth of the earning assets and the interest margin the bank is earning on the assets. If a bank is in an area that provides some growth, earnings can increase even if margins are stable. **[AIMR FINSER INDUSTRY, p. 43]**

Asset growth sometimes provides a clue about what is going to happen to asset quality, and changes in growth rates often foreshadow changes in the loan quality or the level of noncurrent loans at a bank. Currently, the most important category to examine for asset quality is real estate. **[AIMR FINSER INDUSTRY, p. 43]**

The quality of bank management is an important consideration. **[AIMR FINSER INDUSTRY, p. 47]**

Another thing [to] look for in a management is shareholder orientation. Although a shareholder orientation is important in most industries, the divergence between management's payoff matrix and what shareholders want to see seems to be wider in the banking industry. **[AIMR FINSER INDUSTRY, p. 47]**

To determine whether banks are shareholder oriented, analysts have to watch what they do rather than listen to what they say. Their actions must be consistent with maximizing shareholder wealth. **[AIMR FINSER INDUSTRY, p. 47]**

The banking environment is another important consideration. **[AIMR FINSER INDUSTRY, p. 48]**

The factionalization of our banking system is the byproduct of regulation. To a large extent, these rules now have changed. Banks have been deregulated on the product front and also geographically, state by state. **[AIMR FINSER INDUSTRY, p. 48]**

[According to Pringle,] asset quality is important because banks' and thrifts' returns are so low that they cannot afford to take losses. Therefore, it is important for analysts to get numbers that conform to these four categories: nonaccrual loans, renegotiated loans, 90-day past due and accruing loans, and other real estate owned. Thrifts do not always disclose these data, and banks have just begun to disclose loans in the renegotiated category. The 90-day past due category will probably include a lot of FHA/VA loans and some student loans, but you will also find some loans that should be on nonaccrual. Although regulation has intensified and has narrowed discrepancies, a huge amount of management discretion remains in disclosure of nonperforming asset levels. **[AIMR FINSER INDUSTRY, p. 52]**

A general breakdown of least-risky to most-risky assets is as follows: Single-family mortgages, home equity loans, commercial business loans, other consumer loans, commercial real estate loans, and construction loans. Institutions with high-risk profiles and low nonperforming loans are suspect. Beware of institutions with high levels of nonaccrual real estate assets and very low amounts of other real estate owned, because these loans will migrate into "other real estate owned" at a prohibitive cost. Generally speaking, for banks and thrifts, a level of nonperforming assets less than 2 percent in this environment is knocking the ball out of the park; more than 8 percent is very risky. **[AIMR FINSER INDUSTRY, p. 52]**

For comparison between banks and thrifts, [Pringle] suggest[s] using these ratios: nonaccrual plus renegotiated plus 90-day past due loans plus other real estate owned (OREO), divided by total loans plus OREO. **[AIMR FINSER INDUSTRY, p. 52]**

The investment portfolio is something most analysts overlook. Due diligence on U.S. Treasury securities is not necessary, but disclosure elsewhere in the portfolio is not very good--usually one footnote somewhere. Among the things to watch out for are maturity mismatches, for which thrifts are notorious. Banks are less notorious for this problem, although they do it as frequently. Another item to watch for is nongovernment-guaranteed mortgage-backed securities (or private issues); they do not have as high a credit quality. Third, equity portfolios are seldom divulged in financial statements; nor are venture capital portfolios, which both banks and thrifts carry. Junk bonds are a fading issue since regulators have cracked down on them. **[AIMR FINSER INDUSTRY, p. 52]**

Off-balance-sheet exposures get almost no recognition from analysts. Typically, banks have futures and forward contracts, interest rate exchange agreements, foreign exchange, commitments to extend credit, standby letters of credit, and recourse liability. Thrifts usually limit themselves to futures, forward contracts, and interest rate exchange agreements for managing the difference in the pricing of assets and liabilities. **[AIMR FINSER INDUSTRY, p. 53]**

Thrift analysts can look at several specific areas to estimate the impact of off-balance-sheet operations. The biggest risks are in mismatched interest rates and maturity schedules. Analysts should find out if a thrift has a huge amount of interest rate exchange agreements coming due in any given period and whether it can refinance them at the same cost. Analysts should also check for deferred gains and losses. If a thrift sets up a position and takes a loss in it, it is allowed to defer its losses over a certain period. This can be an opportunity because if these losses go away, the profitability of an institution can go up. **[AIMR FINSER INDUSTRY, p. 53]**

Analysts should also check for undispersed lending commitments. **[AIMR FINSER INDUSTRY, p. 53]**

[According to Pringle,] the best way to analyze [bank or thrift] revenues, regardless of the industry, is to look at price and volume. Margins represent pricing; earning assets represent volume. This approach makes estimating earnings on the basis of historical data much easier. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 53]**

Expense ratios, used to figure out how efficient a financial institution is, must be analyzed differently for banks and thrifts. Thrifts look at interest expense as a percent of earning assets. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 54]**

Banks tend to look at what is known as an efficiency ratio. This ratio is derived as follows: The denominator is net interest income before loan loss provision and fully taxable equivalent adjustment plus noninterest income less securities gains; the numerator is operating expenses. **[AIMR FINSER INDUSTRY, p. 54]**

[Accordingly to Frinquelli,] company valuation depends on a variety of internal conditions and considerations, including competition, volume, surplus and return management, and loss reserves policies. For a property/casualty company, the important considerations are what it writes, where it writes it, and how it writes it--or to put it another way, product, geography, and distribution. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 73]**

Competition has two aspects: the type of company and the degree of concentration. Because the life and nonlife businesses are so different, [Frinquelli] treat[s] them separately, beginning with the nonlife segment. **[AIMR FINSER INDUSTRY, p. 73]**

The first word that comes to most analysts' minds when thinking about the property/casualty insurance business is competition. This is a viciously competitive business. **[AIMR FINSER INDUSTRY, p. 73]**

The most obvious form of competition in any business is market share. Most insurance managers consider the term market share to be a bad word. **[AIMR FINSER INDUSTRY, p. 73]**

The companies have several good reasons to pursue increased market share in what might appear to be an unprofitable business. One is that they need volume so they can reduce their exposure to loss from an individual policy; they need to spread risk over more policies. **[AIMR FINSER INDUSTRY, p. 73]**

The critical mass for an insurance company depends on what the company does. Does it concentrate on one line of business, or is it a national writer of all major lines of business? [Frinquelli's] analysis suggests that a company that wants to be a national, multiple-line writer of property/casualty insurance should have premium volume of approximately $3 billion to develop and maintain the kind of critical mass necessary. Critical mass includes maintaining an agency plant, branch office network, and computers. Technology has run amok in the insurance business for the past 15 years and is becoming very expensive. **[AIMR FINSER INDUSTRY, p. 73]**

Analysts should look at the breakdown between fixed and variable costs. Generally, 60 percent of the costs in this business are variable (mainly commissions paid to agents) and roughly 40 percent are fixed. **[AIMR FINSER INDUSTRY, p. 73]**

Another important internal factor is the company's capital, or surplus. Obviously, the amount of surplus (or net assets) determines to a great degree how much business a company can write. If surplus goes up a lot, a company can write more business. If surplus goes down, the company may have to write less business. **[AIMR FINSER INDUSTRY, p. 73]**

A number of factors determine a company's surplus. On the asset side, property/casualty balance sheets are dominated by publicly traded bonds. Bonds are carried at amortized cost, so the values do not jump around for regulatory purposes. In contrast, the stock market has a direct effect on surplus, because stocks are carried at market. **[AIMR FINSER INDUSTRY, p. 74]**

One thing for analysts to watch for is the way companies handle bad markets. For example, an insurance company can manufacture surplus by selling bonds when the market goes up. Some companies are already doing that, not only to be able to write business but also to pay dividends. **[AIMR FINSER INDUSTRY, p. 74]**

Reserve policy is another key internal consideration in the nonlife insurance business. Loss reserves are estimates subject to change. Normal loss reserves are about two-thirds of a casualty company's liabilities and amount to roughly four times surplus. **[AIMR FINSER INDUSTRY, p. 74]**

Analysts must evaluate the quality of [insurance company] management. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 75]**

The external factors can be as important as the internal factors in analyzing an insurance company. Analysts often claim that you only need to know two things to invest in insurance stocks--interest rates and premium rates: premium rates up, stocks up; interest rates down, stocks up. Furthermore, if you are only allowed to know one of those two things on a near-term basis, you want to know the direction of interest rates rather than the direction of premium rates. In addition to interest rates, insurance companies are affected by regulatory activities, inflation, demographics, and globalization. **[AIMR FINSER INDUSTRY, p. 75]**

Interest rates are important to investors because changes have a direct impact on an insurance company's market value. Most insurance company stocks are driven by mark-to-market book value rather than a given year's operating earnings. Marking to market essentially means marking the bonds to market. When interest rates go down, investor wealth accumulates, because the value of the bonds--which often represent three-quarters of an insurance company's assets--goes up. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 75]**

[According to Cope,] loss-development analysis involves examination of a company's paid losses and reserves. **[AIMR FINSER INDUSTRY, p. 81]**

Over the long term, premium increases should reflect inflation and loss experience. **[AIMR FINSER INDUSTRY, p. 81]**

When paid losses rise faster than earned premiums, illustrated by a rising paid loss ratio, the fundamental profitability of the company is under pressure. **[AIMR FINSER INDUSTRY, p. 81]**

Analysts should also compare the growth of written premiums with the growth of expenses. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 84]**

The expense ratio is a basic measure of the company's efficiency. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 84]**

[A]n analysis of operations [also] addresses investment income. Investment income is determined by three factors: cash flow, interest rates, and investment policy. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 84]**

A simple approach to analyzing and projecting cash flow is to equate operating cash flow, excluding proceeds from sale or maturity of investments, to written premiums less paid losses and expenses. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 84]**

Analysts should carefully scrutinize a property/casualty company's reserves. The most comprehensive information on reserves is found in Schedule P of the annual statement each company must file with state insurance regulators. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 86]**

One common way of analyzing reserves is to review the relationship between paid and incurred losses and how that changes over time. Changes in the ratio can provide valuable insight into the company. This is known as the ratio of paid to incurred loss. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 88]**

[According to Picoult,[9]] the following items are critical in analyzing the balance sheets and income statements of life insurance companies. The mix of assets compared to industry averages is important, but a mutual company should be compared against the mutual segment of the business, a stock company against the stock segment, and so forth. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 97]**

The proportions of volatile and nonvolatile assets are also important--specifically, noninvestment-grade (junk) bonds and problem mortgages compared to the rest of the portfolio. NAIC categorizes insurance company assets into six grades according to quality. Categories one and two are considered investment grade, and three through six are considered to be, in varying degrees, questionable or impaired assets. [Picoult] relate[s] the noninvestment grade-issues to a company's statutory surplus, and include[s] the mandatory securities valuation reserve. [Picoult] also [tries] to get specifics on private placements and what portion of the portfolio they represent. Analysis of private placements should be similar to the analysis of publicly traded bonds. In many instances, the private placements are of better quality than some of the public debt. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 97]**

Reserves must be analyzed [according to Picoult]. Insurance companies must set up various types of reserves, and analysts should be able to get those figures from the companies on a quarterly basis, although companies provide only annual data. [Also included in 1(c) and 11(a)] **[AIMR FINSER INDUSTRY, p. 97]**

[According to Picoult,] the revenue mix is the most important item on the income statement. Analysts should determine what portion is premiums, what portion is net investment income, and what is "other" income. The sources of the other income figures are important. For example, the company may have separate operations or subsidiaries that generate other income. For many holding companies, just determining what they own is difficult; the information may be buried in the other income category, and sometimes it is worthwhile to go digging. [Also included in 1(c) and 5(a)] **[AIMR FINSER INDUSTRY, p. 97]**

Premium mix is important. Analysts should determine the mix of ordinary life, annuities, group, and individual policies. They should determine whether the health component is a health maintenance organization or traditional indemnity and to what extent it is experience rated. A certain persistency factor relates to each of these lines of business, which should provide some information about the consistency of the company's revenue flow. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 97]**

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[9] Myron M. Picoult, Managing Director, Senior Insurance Analyst, Oppenheimer & Company, Inc.

Analysts should examine both first-year and renewal premiums. The bulk of the premiums for an insurance company are renewals. A dropoff in sales does not necessarily translate into an immediate diminution in premiums. If people are pulling back in the marketplace because they do not like the current pricing, that is not necessarily a negative. If as they are pulling back they clean up and restructure their insurance plan, that could prove to be positive if it enhances persistency net of business being lapsed. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 97]**

Net investment income has become an increasingly important and sensitive factor because it is a big number for most companies. Analysts should determine the average yields the company is getting on the various types of assets in its portfolio. In addition, they should look at the maturity of the bond portfolio. How much has come due or is coming due? This is a particular problem in the current interest rate environment. For example, because of the concerns being raised by rating agencies today, many life insurance companies are forced to keep a bigger chunk of their asset base in short-term instruments. With the rather precipitous drop in short rates, many of these companies have suffered a double hit. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 97-98]**

Loadings are important as well. Analysts should determine to what extent companies try to adjust for changes in mortality, expense, and morbidity experience. They should also evaluate how timely the companies are in making the adjustments. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

Expenses are absolutely critical to the evaluation of an insurance company. Trends in expenses are particularly revealing. Analysts should evaluate any successes companies may have had in trimming their expenses and to what extent they could become more efficient. That is one of the key factors that will separate successful companies during the coming years. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

Finally, pricing is an important factor in the valuation of insurance companies. Is the price of insurance going up, sideways, or down? [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

An insurance company's total mortgage and real estate exposure relative to its invested asset base is important. . . . [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

At a minimum, a company's holdings should be compared against some industry standard. The American Council of Life Insurance publishes quarterly industry data on real estate holdings. Analyzing the data for a company can provide valuable clues about its strength. For example, the geographic spread may indicate where economic problems are occurring and what the company's mortgage exposure is in those areas. Similarly, the mix of the mortgage portfolio among apartment buildings, strip shopping centers, convention facilities, hotels, office buildings, and so forth provides valuable information on the potential problem areas for the company. Different types of facilities have different delinquency rates, and knowing whether the company has more or less exposure to delinquency risk is important. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

Another helpful piece of information is the average size of a company's real estate loans. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

The lease maturities are also an important consideration, particularly if the asset-type mix or the geographic locations of the mortgages are a concern. Analysts should examine the mix of maturities and determine whether the leases are subject to an increasing rate of rollover during the next few years. Clearly, the sublet market is obfuscating some of the trends in rental rates. Although the sublets may be stabilizing, the key point is that when a mortgage was first made, a certain rental rate was assumed to be needed to service that mortgage. In many instances, the rental rates prevailing now would not be sufficient to cover mortgage service. That explains the writedowns and adjustments in property values. Not all mortgages are bad, but some obviously will have to be adjusted. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

If maturity seems to be a problem, analysts should find out as much as possible about the tenant mix. Are the tenants strong or weak? What kinds of corporate entities are involved? Is it an industry going through a shrink mode? Is it an industry that is holding its own? A sizable exposure to tenants that are in the financial services business will be viewed differently today than it was two or three years ago, because that industry is going through a certain amount of shrinkage. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

The types of mortgages written are also important. For example, analysts should determine whether the company writes bullet mortgages, and if so, when they come due. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98]**

Analysts should examine the specifics of any mortgage foreclosures, restructurings, and delinquencies. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 98-99]**

All of this information on real estate holdings should be related to statutory surplus, because GAAP surplus is not a meaningful number. Regulators and rating agencies look at statutory, not GAAP, numbers. The statutory numbers are supposed to back up fluctuations and pick up any shortfall that might occur. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 99]**

Once a company's mortgage holdings have been examined, analysts should look at the reserves the company has established. How much? How are they being funded? Over what period of time? Setting up appropriate reserves is not an easy thing to do. Not every problem mortgage is going to be worthless. Most mortgages have some value, in contrast to some construction and development loans. Nevertheless, some type of reserve must be set up to cushion some of the loss in value. Insurance companies differ widely in how they set up loss reserves, if they do at all. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 99]**

The two important leverage ratios are surplus to invested assets and surplus to total assets. In calculating leverage ratios, [Picoult] use[s] the statutory data. The mandatory securities valuation reserve can be included or excluded, as long as this is done consistently. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 99]**

Some interesting nuances differentiate the leverage relationships for the different segments of the industry. For example, for the mutual companies, the average ratio of surplus to total assets is about 4.6 percent; for stock companies, it is about 8.2 percent. These ratios have been tracked historically for each segment of the business to see how volatile they have been. The ratios for the stock and the mutual segments of the business have been fairly consistent. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 99]**

The makeup of statutory surplus is becoming increasingly critical. Analysts should determine whether any subsidiaries are included in the surplus number. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 99]**

The advent of risk-based capital standards, according to which companies must allocate surplus by business line, is leading to some interesting if not difficult situations. Companies are beginning to complain about this requirement, because it focuses attention on their surplus. People are looking to see if, for example, some type of surplus note is involved--and, if so, whether the surplus is questionable or clean. The cleaner the surplus, the better off the investor. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 99]**

Persistency is another important factor. Persistency measures how long the business stays on the books once it is sold and how long it feeds the company premium volume. Usually, during the first 12 to 18 months of a life insurance policy, persistency is fairly low. The buyers are keenly aware of the price they are paying for the policy and the sacrifice they are making for an intangible commodity. An advantage of new sales is that the insurance company gets fresh underwriting information on that risk, so the disadvantage of low persistency is offset somewhat by the improvement in aggregate underwriting experience. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 106]**

The loss ratio is an important factor in analyzing an insurance company. The loss ratio is the relationship of all of the losses the company is paying out currently, plus the loss reserves it is adding. Paid losses and loss reserves both are related to earned premiums. If we add the loss ratio to the cost of booking that business, mainly commission expense, the sum of the loss ratio and the expense ratio equals the combined ratio. One of these component parts relates to earned premiums and the other relates to written premiums, which effectively gives consideration to the cost of new business. [Also included in 1(c)] **[AIMR FINSER INDUSTRY, p. 106]**

In discussing whether and how fair value information would be useful in accomplishing their analyses, the analysts drew a clear distinction between fair value accounting on a comprehensive basis and supplemental fair value disclosures. They were almost unanimously opposed to any fair value adjustments that would be reflected in financial statements. Their underlying rationale was that banks are financial intermediaries over an intermediate term. To estimate the fair value of a bank's assets and liabilities, particularly for items that are not traded or held for sale, was seen as ignoring a bank's basic purpose and considered of no value. [Also included in 4] **[KPMG BANK STUDY, p. 38]**

Fair value information was seen by some analysts as being more indicative of liquidation value than of going concern value, and it was noted that a combination of these two issues in the financial statements would result in a confusing and irrelevant product. Several analysts commented that temporary fluctuations in fair value were not particularly important. Others stated that fair value adjustments would not enhance their analyses, confuse existing historical data, and be considered a step backward. [Also included in 4] **[KPMG BANK STUDY, p. 38]**

In contrast, analysts objected less to supplemental disclosures of fair value information, although they were still not overly supportive. Their views ranged from considering fair value disclosures helpful on a supplemental basis to viewing it as information that was interesting but not particularly useful. Others stressed that the subjectivity inherent in estimating fair value renders the information irrelevant and potentially misleading. [Also included in 4] **[KPMG BANK STUDY, p. 38]**

Analysts were concerned about both fair value accounting and fair value disclosures changing bank management's behavior when more attention is focused on fair value information. Specifically, they were concerned that management's focus would change from intermediate- to short-term assets. [Also included in 4] **[KPMG BANK STUDY, p. 38]**

Analysts indicated that if fair value disclosures were to be made, their preference would be to have all financial instruments fair valued. They also indicated that the fair value of intangible assets should be disclosed, specifically citing core deposit premiums. With respect to fair value disclosures for loans, analysts indicated that detailed information underlying the estimates, including methodologies and assumptions, should be provided. They stated that fair value disclosures for loans would be meaningless if these judgmental inputs could not be analyzed. Some preferred receiving the underlying information so they could compute fair value estimates themselves.[Also included in 4] **[KPMG BANK STUDY, p. 38]**

Focus Group Comments, Analysts: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 1(c), 2(a), 2(b), and 4,] **[KPMG BANK STUDY, p. 39]**

- Desired detailed information underlying fair value estimates so they could compute the fair value themselves and compare the results to other institutions [Also included in 1(c) and 4] **[KPMG BANK STUDY, p. 39]**

- Preferred detailed information that would allow them to perform their own calculations [Also included in 1(c) and 4] **[KPMG BANK STUDY, p. 39]**

The quality and usefulness of the information available to the public is an integral part of the analysis of a financial institution's performance and of its estimated value. The questions in this section address the usefulness of the existing financial information and [analysts'] views toward enhancing such information: [Also included in 2(a), 2(d), 4, and 15] **[KPMG BANK STUDY, p. A-3]**

1(b). **Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information—Page 107**

- **Indicate the importance of the following current financial statement disclosures.**

	Very Important	Important	Not Important	No Response
Net interest spread	85%	13%	2	
Regulatory capital adequacy	70	30		
Liquidity	35	53	10	2
Interest rate management	48	50	2	
Credit quality	95	5		
Investment portfolio maturities	15	68	17	
Investment portfolio yields	23	60	17	
Unrealized gain and loss disclosures	43	55	2	
Loan concentration	83	15	2	
Contractual loan maturities	3	53	44	
Fixed vs. variable rate loan information	18	65	17	
Loan portfolio yields	33	60	7	
Non-accrual, past due and restructured loans	100			
Other potential problem loans	93	7		
Charge-off and recovery experience	85	15		
Allocation of allowance by loan type	35	40	20	5
Deposit mix	40	53	7	
Off-balance-sheet instruments	23	70	5	2
Five-year summary data	43	45	5	7
Other (principally includes intangibles and segment data)	21	6		

[Also included in 2(a)] **[KPMG BANK STUDY, p. A-3]**

- **The Financial Accounting Standards Board (FASB) has recently issued Statement No. 107, "Disclosures about Fair Value of Financial Instruments" which requires additional disclosures of fair value estimates for assets, liabilities and off-balance-sheet financial instruments to be part of the basic financial statements for years ending after December 15, 1992. Indicate the expected usefulness of the fair value disclosures for the following financial instruments.**

1(b). **Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information—Page 108**

	Very Useful	Useful	Not Useful	Not Applicable
Loans	25%	40%	30%	5%
Deposits	25	33	40	2
Long-term debt	15	50	33	2
Financial guarantees	23	38	38	1
Commitments	18	33	45	4
Letters of credit	23	43	33	1
Swaps, options, futures, etc.	33	53	10	4
Other	3	3	3	

[Also included in 4] **[KPMG BANK STUDY, p. A-4]**

- **Although fair value disclosures for the following items are not currently required, indicate if you believe fair value disclosures of these items would be useful in your analysis of an institution.**

	Very Useful	Useful	Not Useful
Core deposit intangibles	18%	48%	34%
Lease receivables	8	53	39
Other			
Goodwill		3	

[Also included in 4] **[KPMG BANK STUDY, p. A-5]**

- **Indicate how time lags in reporting financial information to stockholders and the public will effect the usefulness of fair value disclosures (e.g., the December 31 financial information is not normally issued until the following February or March).**

5% No effect on usefulness
55 Marginally diminish the usefulness
33 Greatly diminish the usefulness
7 No opinion
[Also included in 4] **[KPMG BANK STUDY, p. A-5]**

Indicate the length of time that could reasonably pass between estimating fair values and reporting financial information before the usefulness of the disclosures are <u>marginally</u> diminished.

48% One month
35 Between 2 and 3 months

10 Between 4 and 6 months
3 More than six months
4 No response
[Also included in 4] **[KPMG BANK STUDY, p. A-5]**

Indicate the length of time that could reasonably pass between estimating fair values and reporting financial information before the usefulness of the disclosures are <u>greatly</u> diminished.

10% One month
25 Between 2 and 3 months
40 Between 4 and 6 months
20 More than six months
5 No response
[Also included in 4] **[KPMG BANK STUDY, p. A-5]**

The FASB, the Securities and Exchange Commission (SEC) and other regulatory bodies are currently considering a requirement to prepare financial statements based on market values in place of financial statements prepared on a historical cost accounting basis. The questions in this section relate to this issue: [Also included in 2(a), 2(b), 2(c), 4, 10(b), 11(a) and 15] **[KPMG BANK STUDY,
p. A-9]**

1(b). **Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information—Page 110**

- **Select one of the following letters that best describes the usefulness of the following financial statement presentations:**
  a. Very useful
  b. Useful
  c. Not useful
  d. No opinion/No response

A	B	C	D	
8%	68%	24%		Historical cost without fair value disclosures
70	25	2	3	Historical cost with fair value disclosures
8	18	70	4	Financial statements adjusted to reflect fair value
30	28	42		Two separate financial statement presentations, one based on historical cost and one based on fair value accounting

[Also included in 4 and 15] **[KPMG BANK STUDY, p. A-9]**

One of the objectives of financial reporting is to provide information to analysts, investors, creditors and others that is useful in making investment, credit and other financial decisions. The questions in this section relate to the analysis of financial information and [analysts'] views relating to the importance and usefulness of various financial disclosures: [Also included in 1(c), 1(d), 4 and 10(d)] **[KPMG BANK STUDY, p. A-16]**

- **In your analysis of an institution, indicate the usefulness of the following sources of information.**

	Very Useful	Useful	Not Useful	Not Applicable/ No Response
Audited financial statements	83%	17%		
SEC filings	70	25		5
Call reports	28	53	10	9
Published research	13	55	20	12
Other,				
Management interviews	13			

[KPMG BANK STUDY, p. A-16]

1(b). Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information-- Page 111

- **When performing your analysis of an institution, indicate the importance of the following items.**

	Very Important	Important	Not Important	Not Applicable/ No Response
Normalized earnings trends	65%	30%	5%	
Asset/liability management	28	68	4	
Fair value of assets	10	58	32	
Liquidation value	10	43	43	4
Peer group comparisons	45	55		
Loan concentrations	78	22		
Level of non-performing assets	90	10		
Historical credit losses	58	42		
Price to earnings ratio	55	35	5	5
Book to market value ratio	30	63	5	2
Capital adequacy	80	20		
Cash flow information	15	38	43	4
Other	13	9		

[KPMG BANK STUDY, p. A-19]

Estimates of fair value may vary by institution because of different assumptions, methodologies and the practicability of such disclosure. The following questions relate to the reliability and comparability of fair value estimates: [Also included in 1(c), 1(d), 2(b), and 4)] **[KPMG BANK STUDY, p. A-20]**

1(b). **Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information— Page 112**

- **Indicate the importance of disclosures relating to the following items used by the institution to estimate fair value.**

	Very Important	Important	Not Important	No Response
Specific methodology used to estimate fair value	85%	10%		5
Discount rates	83	13		4
Estimated amount of cash flows	48	45	3	4
Estimated timing of cash flows	48	45	3	4
Other relevant assumptions	43	45	3	9
Source of market prices	58	33	5	4
Sensitivity of fair value estimates to changes in assumptions	68	25	3	4
Other				
Availability of true markets	3			
Changes in assumptions since last published		3		

[Also included in 4)] **[KPMG BANK STUDY, p. A-21]**

1(b). Types of Information That Investors and Creditors Use and the Relative Usefulness of that Information--Page 113

Each rating analysis [of a company by S&P] begins with an assessment of the company's environment. To determine the degree of operating risk facing a participant in a given business, S&P analyzes the dynamics of that business. The analysis focuses on the strength of industry prospects, as well as competitive factors affecting that industry. [Also included in 1(c) and 10(d)] **[S&P, p. 15]**

The many factors assessed include industry prospect for growth, stability, or decline, and the pattern of business cycles. It is critical to determine vulnerability to technological change, labor unrest, or regulatory interference. Industries that have long lead times or that required fixed plant of a specialized nature face heightened risk. The implications of increasing competition are obviously crucial. S&P's knowledge of investment plans of the major players in any industry offers a unique vantage point from which to assess competitive prospects. [Also included in 1(c), 10(d), and 13] **[S&P, p. 15]**

As part of the industry analysis, key rating factors are identified--keys to success and areas of vulnerability. A specific company's rating is affected crucially by its ability to achieve success and avoid pitfalls in its business. [Also included in 1(c), 10(b), 10(d), and 13] **[S&P, p. 16]**

The basis for competition determines which factors are analyzed for a given company. [Also included in 1(c), 10(b), 10(d), and 13] **[S&P, p 16]**

For any particular company, one or more factors can hold special significance, even if that factor is not common to the industry. For example, the fact that a company has only one major production facility should certainly be regarded as an area of vulnerability. Similarly, reliance on one product creates risk, no matter how successful that product. For example, one major pharmaceutical company has reaped a financial bonanza from a single drug. The firm's debt is highly rated, given its exceptional profits and cash flow--but it would be viewed still more favorably if it were not dependent on a single medication, which is subject to competition and patent expiry. [Also included in 1(c), 10(b), 10(d), and 13] **[S&P, p.16]**

When a company participates in more than one business, each segment is analyzed separately. A composite is formed from these building blocks, weighting each element according to its importance to the overall organization. Then the potential benefits of diversification, which may not be apparent from the additive approach, are considered. [Also included in 1(c), 10(b), 10(d), and 13] **[S&P, p. 16]**

Market share analysis is often an important rating consideration. However, large shares are not always synonymous with competitive advantage or industry dominance. For instance, if an industry has a number of large but comparably sized participants, none may have a particular advantage or disadvantage. conversely, if an industry is highly fragmented, even the large firms may lack pricing leadership potential. [Also included in 1(c), 10(b), 10(d), and 13] **[S&P, p. 16]**

Management is assessed for its role in determining operational success, and also for its risk tolerance. The first aspect is incorporated in the competitive position analysis; the second is weighed as a financial policy factor. [Also included in 1(c) and 13] **[S&P, p. 19]**

Essentially, subjective judgments lead to S&P's conclusions regarding each aspect of management evaluation. Opinions are formed during the meetings that regularly take place with senior management. While management's track record may seem to offer an objective basis for evaluation, it often is difficult to determine how results should be attributed to management's skills. S&P must decide to what extent they are the result of good management, devoid of management influence, or achieved despite management. [Also included in 1(c) and 13] **[S&P, p. 19]**

Plans and policies have to be judged for their realism. Management credibility is an important factor. Once earned, credibility can support continuity of a particular rating. When a company is faced with stress or restructuring, S&P often will rely on management to carry out plans for restoring creditworthiness. Otherwise, S&P's view is that stated policies often will not be followed, and the ratings will reflect that skepticism. [Also included in 1(c) and 13] **[S&P, p. 19]**

S&P's evaluation also is sensitive to potential organizational problems. These include situations where:

- there is significant organizational reliance on an individual, especially one who may be close to retirement.
- the finance function and finance considerations do not receive high organizational recognition.
- management transition--to professional and organizational from entrepreneurial or family-bound--has not yet been accomplished.
- a relatively large number of changes occur in a short time.
- the relationship between organizational structure and management strategy is unclear.
- a substantial presence by one or a few shareholders exists, imposing constraints on management prerogatives. [Also included in 1(c) and 13]

[S&P, p. 19]

The organizational structure, first and foremost, needs to be understood in the context of the business environment, including past practices and future needs. [Also included in 1(c) and 13] **[S&P, p. 19]**

Having evaluated the issuer's competitive position and operating environment, the analysis proceeds to several financial categories. To reiterate: the company's business-risk profile determines the level of financial risk appropriate for any rating category. Financial risk is portrayed largely through quantitative means, particularly by using financial ratios. [Also included in 1(c)] **[S&P, p. 19]**

Analysis of the audited financials begins by reviewing the accounting quality. This determines whether ratios and statistics derived from financial statements can be used accurately to measure a company's performance and position relative to competition and the larger universe of industrial companies. The rating process is very much one of comparisons, so it is important to have a common frame of reference. [Also included in 1(c)] **[S&P, p. 19]**

Accounting policies to be reviewed include:

- Consolidation basis (FASB now requires consolidation of even nonhomogenous operations. For analytical purposes, it is critical to separate these and evaluate each of business in its own right.)
- Income recognition (for example, successful efforts versus full cost in the oil industry, and percentage of completion versus completed contract in the construction industry)
- Depreciation methods and asset lives
- Inventory pricing methods
- Amortization of intangibles
- Employee benefits.

[Also included in 1(c)] **[S&P, p. 19]**

Importantly, the impact of purchase accounting and varied off balance sheet liabilities is assessed. To the extent possible, analytical adjustments are made to better portray reality. Although it is not always possible to completely recast a company's financial statements, it is useful to have some notion of the extent performance or assets are overstated or understated. At the very least, the choice of accounting alternatives can be characterized as generally conservative or liberal.[Also included in 1(c)] **[S&P, p. 19-20]**

S&P emphasizes the importance of management's philosophies and policies involving financial risk. [Also included in 1(c)] **[S&P, p. 20]**

The analysis of all the financial categories covers both historical and projected performance. Because a rating is an assessment of the likelihood of timely payment of interest and future repayment of principal, the evaluation emphasizes future performance. However, the rating analysis does not attempt to forecast performance precisely or to pinpoint economic cycles. Rather, the forecast analysis considers variability of expected future performance based on a range of economic and competitive scenarios. [Also included in 1(c)] **[S&P, p. 20]**

The profitability category actually encompasses two analytical areas. First, a company's earning power is measured. In the long run, profit potential is a critical determinant of credit protection. Second, earnings are viewed in relation to a company's burden of fixed charges. Otherwise-strong performance can be affected detrimentally by aggressive debt financing, and the opposite also is true. [Also included in 1(c)] **[S&P, p. 20]**

The more significant measures of profitability are:

- Return on capital
- Profit margins
- Earnings on business segment assets.

[Also included in 1(c)] **[S&P, p. 20]**

While the absolute levels of ratios are important, it is equally important to focus on trends and compare these ratios with those of competitors. Since industries follow different cycles and have different earnings characteristics, what may be considered favorable for one business may be relatively poor for another. [Also included in 1(c)] **[S&P, p. 20]**

S&P evaluates several fixed-charge coverage ratios, but the two primary ones are pretax interest coverage and pretax coverage of interest plus total rents. If preferred stock is outstanding and material, fixed charges are adjusted to include preferred dividends. To reflect more accurately the ongoing earnings available to pay fixed charges, the reported figures typically are adjusted. The effect of LIFO liquidations, foreign exchange gains, and unremitted equity are excluded, as well as those of nonrecurring or extraordinary gains and losses. Similarly, the focus is coverage of interest payable, so adjustments are made where interest has been capitalized. [Also included in 1(c)] **[S&P, p. 20-21]**

Particularly important is management's plan for achieving earnings growth. S&P evaluates whether existing businesses can provide satisfactory growth, especially in a less inflationary environment, and to what extent acquisition--or divestitures--may be necessary to achieve corporate goals. [Also included in 1(c)] **[S&P, p. 21]**

A company's asset mix is a critical determinant of the appropriate leverage for a given level of risk. Assets with stable cash flow or market values justify greater use of debt financing than those with clouded marketability. Adjustments are made for companies with disproportionate amounts of cash, investments, or receivables. [Also included in 1(c)] **[S&P, p. 21]**

Knowing the true values to assign a company's assets is key to the analysis. S&P's analysis highlights materially undervalued or overvalued assets relative to book value so that asset protection can be viewed in an alternate light. S&P considers the profitability of an asset as the basis for determining its economic value. Market values of a company's assets or independent asset appraisals can offer additional insights. However, there are shortcomings in these methods of valuation (just as there are with historical cost accounting) that prevent reliance on any single measure. [Also included in 1(c)] **[S&P, p. 21]**

Off balance sheet items factored into the leverage analysis include:

- Operating leases
- Pension obligations
- Debt of joint ventures and unconsolidated subsidiaries
- Guarantees
- Take-or-pay contracts and obligations under throughput and deficiency agreements
- Receivables that have been factored, transferred, or securitized
- Potential legal judgments or lawsuit settlements

[Also included in 1(c)] **[S&P, p. 21]**

S&P uses various methodologies to determine the proper adjustment value for each off balance sheet item. In some cases, the adjustment is straightforward. For example, the amount of guaranteed debt can simply be added to the guarantor's liabilities. Other adjustments are more complex or less precise. [Also included in 1(c)] **[S&P, p. 21]**

Debt of a joint venture is often apportioned to its parents according to their share of ownership. However, if the venture is more critical to one of the partners' operations, it may be appropriate to burden that partner with a disproportionate amount of the debt. Similarly, the partners' relative ability to service the joint venture debt helps determine the analytical

attribution of the debt. Sometimes owners have little incentive to support the venture's debt if it is large enough in relation to their investment. In those cases, an adjustment would be made to write down the owner's investment, rather than adding debt to their balance sheet [Also included in 1(c)] **[S&P, p. 22]**

In the case of contingencies, an estimate can be developed. [Also included in 1(c)] **[S&P, p. 22]**

The sale or securitization of accounts receivable represents a form of off balance sheet financing. If used to supplant other debt, the impact on credit quality is neutral. (There can be some incremental benefit to the extent that the company has expanded access to capital, but there may also be an offset in the higher cost of such financing.) For ratio calculation, S&P would add back the amount of receivables and a like amount of debt. This eliminates the distorting, cosmetic effect of utilizing an off balance sheet technique and allows better comparison with other firms that have not chosen this avenue of financing. Similarly, if a firm uses proceeds from receivables sales to invest in riskier assets--and not to reduce other debt--the adjustment will reveal an increase in financial risk. [Also included in 1(c)] **[S&P, p. 22]**

The debt-equivalent value of operating leases is determined by calculating the present value of minimum operating lease obligations as reported in the annual report's footnotes. The lease amount beyond five years is assumed to mature at a rate approximating the minimum payment due in year five. [Also included in 1(c)] **[S&P, p. 22]**

The variety of lease types may require the analyst to obtain additional information or use estimates to evaluate lease obligations. This is needed whenever lease terms are shorter than the assets' expected economic lives. For example, retailers report only the first period of a lease written with an initial period and several renewal options over a long term. Another limitation develops when a portion of the lease payment is tied to sales, often the case in the retailing industry. [Also included in 1(c)] **[S&P, p. 22]**

As financing techniques become more innovative, ratio analysis becomes more complicated--and probably more tenuous as well. The analyst distinguishes between the different hybrid debt securities based on their features. [Also included in 1(c)] **[S&P, p. 22]**

Convertible securities are considered debt, albeit at a reasonable capital cost, until they actually convert. Many well-intentioned companies project conversion within a short time but fail to accomplish it. Conversion is subject to enough variables beyond management's control that a prediction of when it might occur becomes presumptuous. [Also included in 1(c)] **[S&P, p. 22]**

Debt sold at original issue discount, such as zero coupon debt, is valued net of unamortized discount (the amount of legal liability) for purposes of capital structure analysis. However, borrowings will increase with time, and the growing amounts are taken into account in cash flow analysis. Since there is no sinking fund provision, the issue matures all at once, creating a very sizable refinancing requirement that could test a company's financial flexibility. The

need to refinance a very large amount at one time can become a challenge unless prudent steps are taken to anticipate the need. [Also included in 1(c)] **[S&P, p. 22]**

Any preferred [stock] that the analyst believes will be refinanced eventually with debt should be viewed as a debt equivalent, not equity, all along. [Also included in 1(c)] **[S&P, p. 23]**

There are preferred stock issues that represent merely a debt alternative for companies that are not current taxpayers and, therefore, do not benefit from tax deductibility of interest expense. Auction preferreds, for example, are "perpetual" on the surface. However, the typical issuer is not motivated to keep such preferreds permanently outstanding. Other redeemable preferred stock issues also are likely to be refinanced with debt once an issuer becomes a taxpayer. Preferreds that can be exchanged for debt at the company's option also may be viewed as debt in anticipation of the exchange. [Also included in 1(c)] **[S&P, p. 23]**

Preferreds with sinking funds represent a hybrid, with elements of debt and equity. Sinking fund requirements are comparable to debt maturities, and rarely does a corporation finance the sinking fund payment through cash flow or with newly issued equity, common or preferred. Rather, the sinking fund payment is met through debt issuance, which results in the sinking fund preferred being just the precursor of debt. It would be misleading to view sinking fund preferreds, particularly that portion coming due in the near to intermediate term, as equity, only to have each payment convert to debt on the sinking fund payment date. Accordingly, S&P views at least that portion of the issuer's sinking fund preferreds due within the next five years as debt. A supplementary analysis views the entire issue as debt, since, presumably, it will eventually be debt. [Also included in 1(c)] **[S&P, p. 23]**

Discussions with company management can help determine whether a given preferred stock issue is intended as a permanent feature of the capital structure, as well as circumstances that might lead to replacement or refinancing. The burden of proof is often the issuer's to show that a preferred transaction represents more than pseudoequity. [Also included in 1(c)] **[S&P, p. 23]**

Earnings power may be the best long-term determinant of creditworthiness, but when an interest or principal payment date arrives, earnings are not what matters. The obligation cannot be serviced out of earnings, which is just an accounting concept; payment has to be made with cash. Although there is usually a strong relationship between cash flow and reported earnings, many transactions and accounting entries affect one and not the other. Analysis of cash flow patterns can reveal a level of debt-servicing capability that is either stronger or weaker than might be apparent from earnings. [Also included in 1(c)] **[S&P, p. 23]**

Cash flow analysis is critical in all credit rating decisions. Lately, it has taken on added importance as the debt market has been increasingly populated by speculative-grade issuers. While companies with investment-grade ratings generally have ready access to external cash to cover temporary shortfalls, junk bond issuers lack this degree of flexibility and have fewer alternatives to internally generated cash for servicing debt. [Also included in 1(c)] **[S&P, p. 23]**

Ratios show the relationship of cash flow to debt and debt service, and also to the firm's business needs. Since there are calls on cash other than repaying debt, it is important to know the extent to which those requirements will allow cash to be used for debt service or, alternatively, lead to greater need for borrowing. [Also included in 1(c)] **[S&P, p. 23]**

Some of the specific ratios considered are:
- Funds from operations/total debt
- Total debt/discretionary cash flow (debt payback period)
- Funds from operations + interest/interest
- Free operating cash flow + interest/interest
- Free operating cash flow + interest/interest + average annual principal repayment obligation (debt service coverage)
- Funds from operations/capital spending requirements
- Capital expenditures/capital maintenance.

[Also included in 1(c)] **[S&P, p. 23]**

Analysis of cash flow in relation to capital requirements begins with an examination of a company's capital needs, including both working and fixed capital. While this analysis is performed for all debt issuers, it is critically important for fixed capital-intensive firms and rapidly growing working capital-intensive firms. [Also included in 1(c)] **[S&P, p. 24]**

The key to determining working capital requirements of a company is, first, to establish a projected growth rate and turnover rates for inventory and receivables. [Also included in 1(c)] **[S&P, p. 24]**

Because S&P sees companies as ongoing enterprises, it expects they will provide funds continually to maintain capital investments as modern, efficient assets. Cash flow adequacy is viewed from the standpoint of a company's ability to finance capital-maintenance requirements internally, as well as its ability to finance capital additions. [Also included in 1(c)] **[S&P, p. 24]**

Another analytical task covered . . . is the evaluation of a company's options under stress. The potential impact of various alternatives to expectations is considered, along with a firm's contingency plans. Access to various capital markets, affiliations with other entities, and ability to sell assets are important factors. [Also included in 1(c)] **[S&P, p. 24]**

Flexibility can be jeopardized when a firm accumulates bank borrowings or commercial paper with the hope of funding out when market conditions improve. Reliance on short-term money or interest-sensitive funds creates obvious risks. An unusually short maturity schedule for long-term debt and limited-life preferred stock also is a negative. [Also included in 1(c)] **[S&P, p. 24]**

A firm's access to various capital markets can become an important factor in financial flexibility. A company's experience with different financial instruments and capital markets

gives management alternatives if conditions in a particular financial market suddenly sour. [Also included in 1(c)] **[S&P, p. 24]**

[A] company's ability to generate cash through asset disposals may enhance its financial flexibility. Potential asset disposals will be considered as providing added flexibility only if S&P believes they can be accomplished under terms acceptable to the company. Management's stated intention to sell certain assets is not enough; awareness of market conditions is also necessary. [Also included in 1(c)] **[S&P, p. 25]**

Pension obligations, environmental liabilities, and serious legal problems are difficult analytical areas. Apart from the question of how to value unfunded pension obligations, there are other implications. A large pension burden can hinder a company's ability to sell assets because potential buyers will be reluctant to assume the liability. This off balance sheet item also has played a pivotal role in discouraging some managements from closing excess, inefficient, and costly manufacturing facilities. Such a closing might require the immediate recognition of future pension obligations and result in a substantial charge to equity, thus impairing the firm's financial flexibility. [Also included in 1(c)] **[S&P, p. 25]**

When there is a major lawsuit against the firm, the analyst may use a range of estimated costs to reflect uncertainty inherent in all litigation. Intangible costs are reflected qualitatively in S&P's assessment of a firm's prospects. Disputes with suppliers or customers can have a long-term effect on a company's competitive position. A well-publicized product failure may cost a company far more in lost sales than payment to any injured individual. A potential liability so large that it seems to threaten a firm's solvency . . . often will limit the company's access to capital, at least temporarily. [Also included in 1(c)] **[S&P, p. 25]**

Discussions about cash flow often suffer from lack of uniform definition of terms. The table illustrates S&P's terminology with respect to specific cash flow concepts. At the top is the item from the funds flow statement usually labeled "funds from operation" or "working capital from operation." This quantity is net income adjusted for depreciation and other noncash debits and credits factored into it. Subtract the net increase in working capital investment to arrive at "operating cash flow." [Also included in 1(c) and 5(c)] **[S&P, p. 25]**

Next, capital expenditures and cash dividends are backed out to arrive at "free operating cash flow" and "discretionary cash flow", respectively. Finally, cost of acquisitions is subtracted from the running total, proceeds from asset disposals added, and other miscellaneous sources and uses of cash netted together. "Prefinancing cash flow" is the end result of these computations, which represents the extent to which company cash flow from all internal sources has been sufficient to cover all internal needs. [Also included in 1(c) and 5(c)] **[S&P, p. 25]**

The bottom part of the table reconciles prefinancing cash flow to various categories of external financing and changes in the company's own cash balance. In the example, XYZ Inc. experienced a $35.7 million cash shortfall in year one, which had to be met with a combination of additional borrowings and a drawdown of its own cash. [Also included in 1(c) and 5(c)] **[S&P, p. 25]**

Cash flow summary: XYZ Corp.

($Mil.)	Year One	Year Two
Working capital from oper. (FFO)	18.58	22.34
Dec. (inc.) in noncash current assets	(33.12)	1.05
Inc. (dec.) in nondebt current liabilities	15.07	(12.61)
Operating cash flow	0.52	10.78
(Capital expenditures)	(11.06)	(9.74)
Free Oper. cash flow	(10.53)	1.04
(Cash dividends)	(4.45)	(5.14)
Discretionary cash flow	(14.98)	(4.09)
(Acquisitions)	21.00	0.00
Asset disposals	0.73	0.23
Net other sources (uses) of cash	(0.44)	(0.09)
Prefinancing cash flow	(35.70)	(3.95)
Inc. (dec.) in short-term debt	23.00	0.00
Inc. (dec.) in long-term debt	6.12	13.02
Net sale (repurchase) of equity	0.32	(7.07)
Dec. (inc.) in cash and securities	6.25	(2.00)

[Also included in 1(c) and 5(c)] **[S&P, p. 25]**

The utility rating methodology encompasses two basic components: qualitative business analysis and financial analysis. Qualitative aspects of a utility's operations are likely to shape the nature of long-term financial results. Therefore, analysis of the industry in which a utility operates, a judgment as to its operating position within that industry, review of regulation, and evaluation of management provide the context for assessing a firm's financial condition. [Also included in 1(c)] **[S&P, p. 26]**

Financial categories are evaluated using quantified measures of relative financial performance, while the business categories require subjective assessment, against the backdrop of economic, social and political trends affecting utility operations. The view is prospective. S&P is concerned with events and results that will shape bondholder protection today and tomorrow rather than those that determined it yesterday. However, historical evaluation is vital in the analytical process, as a tool for identifying strengths and weaknesses, and measuring financial prospects. [Also included in 1(c)] **[S&P, p. 26]**

Assessing service territory begins with the economic and demographic evaluation of the area in which the utility has its franchise. Strength of long term demand for the product is examined from a macro-economic perspective. The staying power of demand is rooted in the service territory economy. It is evaluated by reviewing historical and prospective sales and revenue patterns by customer class and by industry dependence. For example, heavy industrial concentration is viewed cautiously since the utility may have significant exposure to cyclical volatility. A large residential component, on the other hand, produces a more stable and predictable revenue stream. [Also included in 1(c)] **[S&P, p. 26]**

Assessment of present and prospective fuel and power supply is critical to every electric utility analysis, and gauging the long-term natural gas supply position is an important gas pipeline and distribution company consideration. There is no similar analytical category for telephone utilities. [Also included in 1(c)] **[S&P, p. 27]**

[For measures of operating efficiency,] S&P attempts to evaluate the nature of operations from the perspective of cost and quality of service. S&P analysts seek to identify those areas which require management attention in terms of time or money and which, if unresolved, may lead to political, regulatory, or competitive problems. Cost of service is compared against the costs of other utilities in the same regulatory jurisdiction and operating situation. For electric utilities, reliability is also important. The status of utility plant investment is reviewed, with regard to generating plant availability and utilization, and also for compliance with existing and contemplated environmental and other regulatory standards. The record of plant outages, equivalent availability, and capacity factors are examined. [Also included in 1(c)] **[S&P, p. 28]**

[For utilities,] regulation plays a key role in shaping overall financial performance. The utility group meets frequently with commission and staff members, both at S&P offices and at commission headquarters, demonstrating the importance S&P places on the regulatory arena for credit quality evaluation. Input from these meetings and from review of rate orders and their impact weigh heavily in S&P's analysis. [Also included in 1(c)] **[S&P, p. 28]**

S&P follows the progress of major projects to assess if they are well-managed or troubled. The size or magnitude of an electric utility's construction program or a particular asset relative to net worth or net plant in service is an important consideration. Investment in a single asset representing a significant percentage of total investment suggests high risk. Where substantial asset concentration exists, the financial profile of a company may experience wide swings depending on the asset's performance. [Also included in 1(c)] **[S&P, p. 28]**

[For a utility], where non-utility business exposure exists, S&P assesses the degree of business risk inherent in non-utility operations and measures the non-utility investment (both present and prospective) to determine the extent to which utility financial criteria should be adjusted to reflect these factors. In instances where a utility company is affiliated with non-utility businesses through a holding company, factors which contribute to common or separate credit risk are analyzed to determine the impact on the utility's credit quality. [Also included in 1(c)] **[S&P, p. 29]**

Evaluating management [of a utility] is of paramount importance to the analytical process since management decisions affect all areas of a company's operations. While regulation, the economy, and other outside factors can influence results, it is ultimately the quality of management that determines the success of a company. [Also included in 1(c)] **[S&P, p. 29]**

S&P assesses management's demonstrated commitment to a given level of credit quality, as reflected in their business strategies and financial track record. S&P seeks evidence of that commitment through well-reasoned planning for the future, including contingency options to

demonstrate flexibility. Management quality is also indicated by thoughtful balancing of public and private priorities, a record of credibility, and effective communication with the public, regulatory bodies, and the financial community. [Also included in 1(c)] **[S&P, p. 29]**

In the earnings protection category, S&P analysts focus on pretax cash income coverage of all interest charges. For this calculation, allowance for funds used during construction (AFUDC) is removed from income and interest expense. To identify total interest expense, S&P disaggregates from operating expenses the interest component of various off balance sheet obligations, like leases and some purchase power contracts, and includes them in interest expense. [Also included in 1(c)] **[S&P, p. 29]**

While considerable emphasis in assessing credit protection is placed on coverage ratios, this parameter alone does not provide the entire earnings protection picture. Also important are a company's earned return on both equity and capital, measures that highlight a firm's earnings performance. Consideration is given to the interaction of embedded costs, financial leverage, and pretax return on capital. [Also included in 1(c)] **[S&P, p. 29]**

Since utilities are so capital intensive, S&P closely examines a firm's ability to tap capital markets on an ongoing basis. External funding capability complements internal cash flow. Financing flexibility incorporates a utility's financing needs, plans, and alternatives, as well as its flexibility to accomplish its financing program under stress without damaging creditworthiness. Debt capacity reflects all the earlier elements: earnings protection, debt leverage and cash flow adequacy. Market access at reasonable rates is restricted if a reasonable capital structure is not maintained and the company's financial prospects dim. [Also included in 1(c)] **[S&P, p. 30]**

S&P assesses a company's capacity and willingness to issue common equity given various factors, including the market-to-book ratio, dividend policy, and any regulatory restrictions regarding the composition of the capital structure. S&P also reviews indenture restrictions and the likely impact of additional debt on covenant tests. In essence, the analytical effort is geared to determining the number of financing alternatives which can be employed to meet ongoing cash requirements. [Also included in 1(c)] **[S&P, p. 30]**

Assessment of corporate credit quality on an international basis follows the same rating methodology as that employed in analysis of U.S. corporates: industry risk and a company's competitive position are evaluated in conjunction with the firm's financial profile and policies. This fundamental analysis is complemented with an appreciation of relevant industry or financial characteristics of a specific country or region. [Also included in 1(c)] **[S&P, p. 31]**

In the spectrum of debt-like equivalents, pension liabilities fall somewhere between operating leases and certain types of contingent liabilities. Unfunded pension liabilities are not viewed in the same light as straight debt, since the amount to be paid in specific future years can be subject to volatile change. Nor does S&P attempt to precisely quantify a pension obligation using any single method: S&P views the obligation from a few perspectives that in combination capture a firm's exposure. [Also included in 1(c)] **[S&P, p. 43]**

S&P's pension analysis

Step 1: Plan asset rate of return versus discount rate. Plan asset rate of return versus wage growth rate.
Step 2: Plan assets as a percentage of projected benefit obligation
Step 3 Adjust balance sheet for plan assets less projected benefit obligation
Step 4: Recalculate funds from operations as a percentage of total debt
Step 5: Discount ERISA's mandatory payment stream for unfunded obligations
Step 6: Recalculate funds from operations as a percentage of total debt
[Also included in 1(c)] **[S&P, p. 43]**

Use a combination of steps 2, 4, and 6 to assess impact on pension obligations on financial risk profile. [Also included in 1(c)] **[S&P, p. 43]**

The analytical process starts with review of the pension footnote and follows several steps to distinguish underfunded plans from adequate or overfunded ones. Pension reporting improvements under Financial Accounting Standards Board's (FASB) Statement 87 have facilitated S&P's method of factoring pension obligations into rating analysis. However, S&P also emphasizes a plan's funding obligations, apart from determining the size of the liability. These funding obligations are determined by Employee Retirement Income Security Act (ERISA) guidelines, which can use actuarial assumptions and cost methods quite different from those under FASB 87 to determine pension expense and liabilities. In fact, if unfunded pension obligations are a material concern, the cash flow impact of funding requirements plays a bigger role in credit evaluation than the balance sheet information. [Also included in 1(c)] **[S&P, p. 43]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

[Some]. . . analysts. . . have a short-term focus. They are preoccupied with predicting a company's financial performance for the next 18-24 months. Using those predictions of financial performance, they then form judgments about the company's future stock price based on multiples and ratios that they believe the market will apply to those predicted amounts. Those multiples and ratios often include (1) price to earnings, (2) price to book equity, (3) price to cash flow or free cash flow, (4) dividend yield, (5) ratio of book earnings to book equity, (6) ratio of book earnings to book assets, (7) debt to equity ratios, and others. Obviously, the analysts' predictions of future stock prices provides the basis for their buy, hold or sell recommendations. [Also included in 1(a) and 1(c)] **[GOLDMAN, p. ii]**

[Some]. . . analysts. . . follow the anticipation approach. As discussed in the Subcommittee's paper "Methods of Portfolio Management and Identifying Stocks for a Portfolio", investors following the anticipation approach believe that stock prices are closely correlated to reported earnings or the rate of growth in reported earnings. Thus, those investors focus on predicting

book earnings. However, the short-term focus of the anticipation approach distinguishes it from the fundamental approach, which has a longer-term perspective. [Also included in 1(a) and 1(c)] **[GOLDMAN, p. ii]**

To better predict a company's short-term financial performance, the analysts focus on the industry's and company's detailed operations. For example, they desire to understand the nature of the specific products produced and services rendered, they try to predict the demand in units for those products and services, and they seek to understand the detailed costs for a specific company to provide those products and services. Each analyst stressed the importance of industry experience and a detailed understanding of the company's operations. The analysts get that understanding from many diverse sources, including frequent contact with management and periodic field trips to companies. [Also included in 1(a) and 1(c)] **[GOLDMAN, p. ii]**

[One analyst] could not see how fair market value accounting could be implemented for real estate entities. The key issue for real estate firms is the tremendous variance in accounting policies towards expensing items versus capitalizing items. He said that earnings per share is a useless number and that cash flow per share is paramount. He defines recurring net income or net funds from operations as net rents minus G&A minus interest. He feels a meaningful ratio is this number (funds from operations) divided by historical costs of all properties. [Also included in 1(c), 4, and 5(a)] **GOLDMAN, p 1]**

[One analyst] examines 10 K's very carefully. He puts little or no stock in earnings forecasts, which he said are fragile and usually wrong. He emphasized that liquidity trends affect prices for real estate and he repeated his emphasis on cash flow per share. [Also included in 12] **[GOLDMAN, p. 1]**

[Another analyst] covers 13 larger banks in depth and is conversant on the financial operations of about 50 in total. Her emphasis is on earnings and earnings growth. She wants to know what is happening in various financial areas such as loan volume, fees, expenses, loss provision, etc. Her customers are large money managers (funds). She spends approximately 40% of her time on analysis, 40% of her time on sales efforts to buy side investors and 20% on other activities. [Also included in 1(a)] **[GOLDMAN, p. 1]**

Financial statements are imperative for [one analyst] in her work. Her main complaint is that banks should report their revenues and expenses by lines of business (segments). She does not like market value accounting; she feels it will lead to behavioral disadvantages, such as the shortening of the maturities of portfolios. Furthermore, earnings would become far too volatile. She can read the footnotes to find out what she wants to know about market values. [Also included in 3(c) and 4] **[GOLDMAN, p. 1-2]**

[One analyst] wants to know the core earnings of [a] bank. She eliminates unusual and nonrecurring items. She does not use the cash flow statement because she believes bank earnings and cash flow results are very close. She does not use the pension footnote because she cannot understand it. All she wants to know about pensions are the assumptions and if a

plan is over or under funded. She does not understand tax accounting or the tax footnote. [Also included in 5(a)] **[GOLDMAN, p. 2]**

[One analyst] would like more data on off balance sheet items and admits that she eliminates goodwill from the balance sheet. She does admit, however, that other intangibles may have some value. [Also included in 5(b), 7(a), and 7(b)] **[GOLDMAN, p. 2]**

As a private investor, for [one analyst's] own portfolio, she tries to find out as much as possible on the unit volume of the company. She hones in on earnings and reads the MD&A. **[GOLDMAN, p. 2]**

[A third analyst] covers large drug companies that are global in nature and that have market capitalizations of $8 - $60 billion. He says investors are driven basically by the future growth prospects of drug companies. He wants an analysis of the research pipeline, since that will lead to profitability. He focuses on the income statement and the cash flow statement and says that the balance sheet is much less important. [Also included in 1(a)] **[GOLDMAN, p. 2]**

[One analyst's] main complaint is the lack of segment information. He would like drug companies to report product segments by geographic area. He wants information on new products and their margins. [Also included in 3(a), 13, and 15] **[GOLDMAN, p. 2]**

[One analyst] does not read the pension footnote and he assumes that the plan is not underfunded but he says it is comforting to know that the data is there. He does not use the tax footnote but does not read the footnotes on accounting principles or stock options. He does not need the fair value of assets because it will not influence his investment opinions. **[GOLDMAN, p. 3]**

[One analyst's] sources of information are financial statements, K's, Q's, company information packet, and management. He studies the macro picture (the industry). He is particularly fond of obtaining information from the company's prospectus, but when all is said and done he says the financial statements are the most important part of his analysis. [Also included in 13] **[GOLDMAN, p. 3]**

[To one analyst the] most important number is the earnings per share on an operating basis. He looks at the quality of assets for trends but not their specific values. He is not a value investor and does not believe you can implement mark to market across the board. How do you value a loan asset? [Also included in 4] **[GOLDMAN, p. 3]**

[One analyst] believes accounting should strive to avoid volatility in earnings and he stated that the pooling concept makes numbers hard to compare. He believes there should be one standard for accounting and specifically mentioned his unhappiness with the choice of either of LIFO or FIFO. He tends to look at five years back and projects two years forward. [Also included in 1(a), 7(c), and 8(a)] **[GOLDMAN, p. 3]**

[One analyst] clearly wanted an addition to the income statement, namely the average shares outstanding and the primary and fully diluted income per share. **[GOLDMAN, p. 3]**

[One analyst] never uses pension accounting which he said was "oblique and obscure". He just wants to know the key pension assumptions and whether the plan is over or under funded. **[GOLDMAN, p. 3]**

[One analyst] said the bulk of information in financial statements is used by analysts but not by most individual investors. He would like one number on the cash flow statement that shows the result of operations alone, not changes in the various assets. [Also included in 5(c) and 15] **[GOLDMAN, p. 4]**

[A fifth analyst's] job is to determine for investors which stocks to buy, sell, hold, and the timing thereof. He spends more than 1/2 of his time in investment banking. He uses a wide variety of tools and he uses financial statements with a large grain of salt. He seemed to be quite cynical and repeated over and over that earnings can be manipulated. [Also included in 1(a)] **[GOLDMAN, p. 4]**

[One analyst] emphasized his reliance on cash earnings because cash is either there or it's not - you either generate cash or you do not generate cash. **[GOLDMAN, p. 4]**

[One analyst] would like income to be determined more by cash activities than by accrual. He would like more disclosure and reconciliation between cash income and GAAP income every quarter. He feels that the standards are too loose in the allowance of one time charges. [Also included in 5(a) and 15] **[GOLDMAN, p. 4]**

On the pension footnote, [one analyst] said he just wants to know whether the plan is under or over funded. He felt the tax footnote should provide the differential between cash taxes and the tax provision and the reasons therefore. [Also included in 15] **[GOLDMAN, p. 4]**

[Foreign] financial analysts use numerous extra-accounting data (determinant of supply and demand, competition and market shares, . . .) or quantitative data (goods and productive equipment; research and development programs; management; social relationship within the company, . . .). [Also included in 13] **[BETRIOU, p. 1]**

Accounting data published by companies [is] one of the main raw materials for [foreign] financial analysts. **[BETRIOU, p. 1]**

Following is a quick reminder of the specific usefulness of the various accounting documents:
- profit and loss account: development of business, of costs and of profit capacity;
- statement of changes in financial position: examining how capital and financing can be used;
- balance sheet: development, analysis of the financial structure and needs for working capital;
- appendix, most useful to explain accounting statements.

[BETRIOU, p. 1]

Usually, these accounting documents are made available in the following circumstances:
- annual account (more and more often stored in computerized data bases);
- intermediate accounts: quarterly or semi-annual;
- documents required for financial operations (listing, issuing securities).

[BETRIOU, p. 1]

[Foreign] financial analysts mainly use consolidated accounts when available: they reflect the real financial dimension of company groups better, thanks to the elimination of the impact of different legal structures. It is in fact often impossible to apprehend the reality of a group by examining each of the companies it includes. **[BETRIOU, p. 1]**

Further, consolidated accounts are set up after adjustments, which theoretically aim at granting them with a greater economic meaning than that of corporate accounts. For example: the elimination of reserve meant to reduce taxation, calculation of depreciation on an economic basis, standardization of accounting methods for all companies considered. **[BETRIOU, p. 1]**

Beyond the fact that they are raw material for consolidated accounts, corporate accounts remain nonetheless useful, notably to examine a company or when the legal structure does not call for consolidated accounts. Incidentally the latter are often more opaque than corporate accounts which may sometimes help understand and analyse consolidated accounts. **[BETRIOU, p. 1]**

From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 2(c), 2(d), 3(c), 4, 5(a), 5(c), 6, 8(a), 9, 11(b), 11(c), and 15] **[BETRIOU, p. 1]**

Some extremely useful data for [foreign] financial analysts still remains optional or incomplete. It would be preferable that the European directives plan their publication. We are more particularly thinking of:

- Statements of changes in financial position. They are often published by large groups, but with partially dissimilar presentations and with definitions inadequately standardized. [Also included in 5(c) and 15] **[BETRIOU, p. 2]**

- Semi-annual and quarterly accounts (same observation as for statements of changes). The systematic publication of semi-annual accounts (even if non audited, should that be the requisite condition for rapidity), would be considerable progress. They should include the main items of the balance sheet, of the profit and loss account, of the statement of changes, as well as data per activity. [Also included in 11(b), 11(c), and 15] **[BETRIOU, p. 2]**

  Furthermore, it is important that intermediate accounts be set up according to the same nomenclature as the closing accounts, to which financial analysts compare them. [Also included in 11(b), 11(c), and 15] **[BETRIOU, p. 2]**

- Breaking down business, profit and main items of the balance sheet per origin (geographical zones and business segments). This type of data which could be limited to a few major elements of the profit and the balance sheet is still too often unavailable. [Also included in 3(c) and 15] **[BETRIOU, p. 2]**

  The publication of the profit/loss of the main divisions of a group is also desirable, especially when they have appreciably different margin ratios (moreover, when some lose money). This data is in fact particularly useful for examining the development of the total profit. [Also included in 3(c) and 15] **[BETRIOU, p. 2]**

[T]he standardization of accounting data sometimes leads to its impoverishment when new standards plan for less details or less significant data (for [foreign] financial analysts) than the preceeding ones. For example:

- The componants of costs per kind (personnel costs in particular). In the past this data was published in "French type" accounts but are not always included in the appendixes of "anglo-saxon type" accounts, especially in semi-annual publications. [Also included in 15] **[BETRIOU, p. 2]**

- Consolidation through global integration of financial subsidiaries (required by the American SFAS 21 standard). Such practice may obscure groups accounts, whose main business is not finance. The equity method consolidation of subsidiaries seems preferable, with an indication in the appendixes of the impact of their consolidation through global integration. [Also included in 15] **[BETRIOU, p. 2]**

[I]n some countries (in France, notably), priority is still too often given to corporate accounts in published data. Consolidated accounts are then often limited to the minimum requirements of the directives. Progress is being made and should be continued. [Also included in 15] **[BETRIOU, p. 2]**

If it is accepted that the existence of options leads accountants to make different choices, the comparison between companies may nevertheless require the elimination of the incidence of these choices. Published data does not always allow for such process. Consequently, IASC's efforts to reduce the number of options seems to us positive. Such an orientation should also be sought at the European level. [Also included in 2(c) and 15] **[BETRIOU, p. 2-3]**

The case of companies modifying their structures is worth mentioning: comparability in time would be greatly improved by the publication of data with a constant structure over three years (two years are often insufficient to determine trends). [Also included in 2(c) and 15] **[BETRIOU, p. 3]**

In consolidated accounts in particular the impact on the profit and loss account, over a full year, for recently consolidated or deconsolidated companies becomes requisite data in order to make estimates. In our opinion this should be published. Alterations in the consolidation circle during the financial year are presently made "pro rata temporis". [Also included in 2(c) and 15] **[BETRIOU, p. 3]**

It is likely that the objectives of all accounting data users do not coincide. As far as they are concerned, [foreign] financial analysts essentially need data which reflects the economic reality of entities they examine (groups or companies). Further progress is still required and we have broken this down into . . . categories: [Also included in 4, 5(a), 6, 8(a), 9, and 15] **[BETRIOU, p. 3]**

- Fiscal distorsions, too frequent in various European countries (including France, Italy, Germany). It seems to us that these distorsions must be eliminated from corporate accounts, as they are from consolidated accounts. The latter are still too often influenced by fiscality in some countries (Germany, notably). [Also included in 15] **[BETRIOU, p. 3]**

- The impact of legal considerations: generally speaking, off-balance sheet commitments should benefit from more detailed data then they presently do. Pension costs for instance show the importance of these potential debts. [Also included in 15] **[BETRIOU, p. 3]**

- [L]easing should be entered in the assets and liabilities on the balance sheet (and not off the balance sheet which distorts the meaning of debts and fixed assets). Standardization at the European level would be useful. [Also included in 8(a) and 15] **[BETRIOU, p. 3]**

[G]enerally, from the [foreign] financial analysts' viewpoint, seeking economic meaning seems to have to prevail on strictly legal considerations. This principle would lead to setting up consolidated accounts for example in cases when the percentages of shares held do not formally require it. Combinations meant to artificially improve the balance sheet ratios would thereby become transparent. [Also included in 6 and 15] **[BETRIOU, p. 3]**

- Undervaluation of asset items. The differences between accounting valuations and the "economic reality" results notably from:

    [1] the "conservative rule", indeed useful to protect creditors, but which plans for immediate entering of potential loss and does not take into account latent gains. [Also included in 4, 9, and 15] **[BETRIOU, p. 3]**

    More particularly, the historic cost method does not allow showing the potential revaluation of assets. This data would be necessary for investment securities, because of the development of money market funds: part of the financial products are released only when mutual fund shares are sold, distorting the meaning of net financial expenses. [Also included in 4, 9, and 15] **[BETRIOU, p. 3]**

    Data on market values included at least in the appendix would give a more precise view of reality. It could concern in priority current assets (investment securities and raw material notably). [Also included in 4, 9, and 15] **[BETRIOU, p. 3]**

[2] of the too large latitude (allowed by the Fourth Directive) in the determination of provisions which may sometimes be profit. It would be preferable to have stricter allowance criteria. [Also included in 4, 9, and 15] **[BETRIOU, p. 3]**

[3] of the too large liberty to capitalize research and development expenditures which could lead to overestimating profit over a period. [Also included in 4, 9, and 15] **[BETRIOU, p. 3]**

- Exceptional earnings are still too often under detailed. The distinction made with regular profit permits a keener analysis of the past and future profitable developments. [Also included in 5(a) and 15] **[BETRIOU, p. 3]**

[T]he impact of changes in accounting methods, the impact of recently acquired (or sold) businesses, and finally the impact of changes in the consolidation circle (see above) are a source of data which is particularly useful. [Also included in 15] **[BETRIOU, p. 3]**

1.b.133

One of the key dimensions to setting standards for financial reporting always has been to determine just what ought to be important purposes of the reports themselves. Two functions that have been under considerable discussion for some time are measuring and analyzing the performance of a company on the one hand, and a comparison of the company with other companies on the other.

In this study, the extent to which current standards enhance and help the process of carrying out both functions was measured.

Table 1.6

HOW MUCH RULES HELP ANALYSIS OF COMPANY PERFORMANCE AND COMPARABILITY

Q.2A—How much do current rules for financial reporting help the process of . . . (READ EACH ITEM). . . . A great deal, some but not a lot, not much, or do the rules set back that process?

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers			Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Measuring and analyzing the performance of a company														
A great deal	44	47	38	30	36	49	54	51	67	33	53	42	45	41
Some but not a lot	47	42	54	58	50	41	44	42	33	53	40	48	42	53
Not much	6	8	6	9	14	5	2	4	–	7	7	3	8	6
Set back process	2	1	1	3	–	5	–	–	–	–	–	3	3	–
Not sure	1	–	–	–	–	–	–	2	–	7	–	3	3	–
No answer	*	1	–	–	–	–	–	–	–	–	–	–	–	–
Comparing it with other companies														
A great deal	45	44	42	33	36	56	52	44	67	27	40	45	47	41
Some but not a lot	44	50	49	58	46	32	41	38	20	53	40	45	34	41
Not much	9	6	9	9	18	7	5	11	7	13	13	3	11	18
Set back process	1	–	–	–	–	2	–	–	–	–	–	3	3	–
Not sure	1	–	–	–	–	–	2	2	–	7	–	3	3	–
No answer	1	–	–	–	–	2	–	4	7	–	7	–	3	–

*Less than .5%.

By 91-8%, a big majority is convinced that the standards for financial reporting help the process of measuring and analyzing the performance of the company and a comparable 89-9% feel the same about the standards helping the process of comparing that company to others.

Observation: *Clearly, the current standards for financial reporting are widely believed to enhance both the function of measuring and analyzing the performance of companies, as well as the function of comparing companies with each other.*

[CHART 3]

1.6.135

Relative Importance of Key Measures

For a number of years, earnings per share was widely viewed as the primary measure of the health of a corporate entity. However, back in 1980, no more than 49% of the financial community gave this pivotal dimension a rating of "high importance," putting earnings per share in sixth place.

The ensuing five years from 1980 to 1985 have brought other significant changes in what are perceived as key financial measures to focus on:

Table 2.1

TREND ON WHAT IS PERCEIVED AS BEING HIGHLY IMPORTANT TO FOCUS ON IN USING FINANCIAL REPORTS

	1985	1980
Highly Important:	%	%
Cash flows	74	67
Components of earnings, such as operating earnings or income from continuing operations	64	55
Changes in a company's financial position	54	63
Return on investment	51	66
Competitive position or positions in major line or lines of business	39	43
Earnings per share	33	49
Forecasts of future earnings	19	23
Effects of inflation	12	52

The changes over the five-year period obviously have been legion. Cash flows, which had led the 1980 list, now appears to have widened its lead considerably. Components of earnings, such as operating earnings or income from continuing operations, has moved up sharply from fourth to second place. Return on investment and changes in a company's financial position appear to be slipping some. The effects of inflation has dropped precipitously as the perceived threat of inflation has diminished. Earnings per share continues to fade as a critical point of focus.

However, there are still major differences among different parts of the financial community.

[HARRIS]

1.b. 136

Table 2.2

IMPORTANCE OF KEY FINANCIAL MEASURES

		Large Public Companies		Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers	C. E. O.	C. E. O.			Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Highly Important:														
Cash flows	74	72	76	91	75	73	93	58	40	60	73	58	63	76
Components of earnings, such as operating earnings, etc.	64	56	59	64	61	73	82	60	60	53	67	58	53	82
Changes in company's financial position	54	45	53	58	50	71	80	38	27	47	40	45	37	71
Return on investment	51	72	70	36	50	66	31	31	33	27	33	29	42	53
Competitive position	39	23	46	48	50	61	41	27	47	13	20	10	45	65
Earnings per share	33	54	43	27	32	34	7	31	40	27	27	16	42	18
Forecasts of future earnings	19	12	16	21	18	22	25	24	27	13	33	29	11	24
Effects of inflation	12	4	3	12	21	22	11	9	7	7	13	6	26	47

It is evident, for example, that chief executive officers and chief financial officers of large public companies and academics give high importance to return on investment and earnings per share far beyond any other groups, suggesting that they may have a lag in their perceptions, compared with the views of many of those who are drawing financial judgments about their performance. Investment institutions, by contrast, give high importance to cash flows, components of earnings, changes in a company's financial position, return on investment, and competitive position. Bank lending officers concentrate on cash flows, components of earnings, and changes in a company's financial position.

[HARRIS]

Following is a breakdown by respondents of the perceived importance of key financial measures.

Table 2.3

I.b. 137

IMPORTANCE OF KEY FINANCIAL MEASURES: BREAKDOWN BY RESPONDENTS

Q.7A—In recent years, many users of financial information have tended to focus on a single number—earnings per share. Other users insist that a series of numbers, or other kinds of data, must be considered. How do you feel about the relative importance of . . . (READ EACH ITEM)?

		Large Public Companies		C.E.O.				Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Earnings per share														
Highly important	33	54	43	27	32	34	7	31	40	27	27	16	42	18
Somewhat important	51	42	51	67	61	46	52	56	47	60	60	58	34	59
Not very important	14	4	5	6	7	17	36	13	13	13	13	13	24	24
Not important at all	2	–	1	–	–	2	5	–	–	–	–	13	–	–
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Cash flows														
Highly important	74	72	76	91	75	73	93	58	40	60	73	58	63	76
Somewhat important	24	26	20	9	21	27	5	38	53	33	27	42	34	24
Not very important	1	3	1	–	–	–	2	2	–	7	–	–	3	–
Not important at all	*	–	1	–	4	–	–	–	–	–	–	–	–	–
Not sure	*	–	1	–	–	–	–	2	7	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Changes in a company's financial position														
Highly important	54	45	53	58	50	71	80	38	27	47	40	45	37	71
Somewhat important	40	45	43	36	43	27	18	51	60	53	40	52	53	29
Not very important	5	8	4	6	7	2	2	11	13	–	20	–	5	–
Not important at all	1	3	–	–	–	–	–	–	–	–	–	3	3	–
Not sure	*	–	–	–	–	–	–	–	–	–	–	–	3	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Return on investment														
Highly important	51	72	70	36	50	66	31	31	33	27	33	29	42	53
Somewhat important	41	27	25	61	43	29	49	56	53	60	53	65	50	29
Not very important	8	1	5	3	7	5	18	13	13	13	13	6	8	12
Not important at all	*	–	–	–	–	–	2	–	–	–	–	–	–	6
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

Table 2.3 (continued)

1.b. 138 **IMPORTANCE OF KEY FINANCIAL MEASURES: BREAKDOWN BY RESPONDENTS**

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Effects of inflation														
Highly important	12	4	3	12	21	22	11	9	7	7	13	6	26	47
Somewhat important	39	29	32	36	29	49	54	29	13	47	27	42	61	29
Not very important	37	37	51	45	39	22	33	58	80	40	53	35	5	12
Not important at all	12	29	15	6	11	5	2	4	–	7	7	16	8	12
Not sure	*	–	–	–	–	2	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Competitive position or positions in major line or lines of business														
Highly important	39	23	46	48	50	61	41	27	47	13	20	10	45	65
Somewhat important	44	62	42	33	32	27	44	51	47	60	47	58	39	29
Not very important	14	13	11	15	18	7	11	18	7	20	27	23	16	6
Not important at all	2	3	–	–	–	2	3	2	–	–	7	10	–	–
Not sure	1	–	1	3	–	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Forecasts of future earnings														
Highly important	19	12	16	21	18	22	25	24	27	13	33	29	11	24
Somewhat important	42	32	43	33	36	39	54	42	40	40	47	26	66	47
Not very important	27	36	27	18	39	27	18	31	33	40	20	39	18	18
Not important at all	10	17	10	24	7	10	3	2	–	–	–	6	5	12
Not sure	1	3	4	–	–	2	–	–	–	–	–	–	–	–
No answer	*	1	–	3	–	–	–	–	–	–	–	–	–	–
Components of earnings														
Highly important	64	56	59	64	61	73	82	60	60	53	67	58	53	82
Somewhat important	33	41	38	36	36	22	16	36	33	40	33	32	45	12
Not very important	3	3	3	–	–	5	–	4	7	7	–	10	3	6
Not important at all	*	–	–	–	4	–	–	–	–	–	–	–	–	–
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

1.b. 139

Usefulness of More Qualitative or Subjective Financial Information

Yet another issue is the extent to which nonquantitative, subjective, and qualitative financial information are of high use. Indeed, there is widespread recognition that such informal information "often can be more important to users of financial reports."

Table 2.4

USEFULNESS OF QUALITATIVE INFORMATION

Q.7B—Compared with the usefulness of quantitative measures we've just been talking about, do you feel that other financial information, perhaps of a more qualitative or subjective nature, often can be more important to users of financial reports?

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Feel	66	62	59	52	46	63	67	73	73	60	87	74	89	82
Do not feel	26	28	33	42	36	24	25	20	13	33	13	23	5	18
Not sure	8	10	8	6	18	12	8	7	13	7	–	3	5	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Here are the types of qualitative information that were volunteered by these key members of the financial community:

Table 2.5

KINDS OF QUALITATIVE FINANCIAL INFORMATION THAT ARE OF PIVOTAL IMPORTANCE

Q.7C—What kinds of additional qualitative financial information do you have in mind? Base: Feel that qualitative information can be more important to financial users.

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	296	48	47	17	13	26	41	33	11	9	13	23	34	14
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Management observations	15	25	17	29	–	12	2	24	27	11	31	22	6	7
Quality of management capabilities	17	10	9	6	8	15	34	9	18	–	8	26	29	21
Changes in management	2	4	–	–	8	–	2	–	–	–	–	–	6	–
Strategic plans and goals	15	21	26	18	15	8	10	9	18	–	8	–	15	14
Product information	12	6	9	12	–	23	5	18	27	–	23	9	24	14
Financial prospects	9	10	6	–	–	8	10	12	18	–	15	17	12	14

[HARRIS]

1.b.140

Table 2.5 (continued)

KINDS OF QUALITATIVE FINANCIAL INFORMATION THAT ARE OF PIVOTAL IMPORTANCE

		Large Public Companies		Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers	C. E. O.	C. E. O.			Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	296	48	47	17	13	26	41	33	11	9	13	23	34	14
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Market growth	16	13	28	–	23	19	10	6	–	–	15	4	21	50
Technological developments	2	2	2	–	8	–	–	–	–	–	–	–	9	–
Industry trends	6	10	11	6	8	8	5	6	9	–	8	–	3	–
Cash flow/liquidity/ net worth	7	4	4	6	15	15	2	12	–	11	23	13	3	7
Quality of assets	9	–	6	12	–	12	39	3	–	–	8	9	–	7
Quality of earnings	3	4	9	–	–	8	–	3	–	11	–	–	3	–
Regulatory trends	5	2	6	6	8	–	10	–	–	–	–	–	12	14
Competitive elements	12	10	9	12	31	8	12	9	18	–	8	9	21	7
Economic environment	3	4	2	–	–	–	5	3	–	11	–	–	9	–
Debt ratios	2	4	2	–	–	–	–	3	–	11	–	4	–	7
Future earnings prospects	5	8	4	6	8	8	5	–	–	–	–	–	3	7
Contingency liabilities	4	6	2	–	15	4	5	6	18	–	–	–	–	–
Employment practices	5	–	2	–	–	4	7	–	–	–	–	13	9	29
Footnotes to the financial statements	2	–	4	–	–	4	2	–	–	–	–	–	3	–
Accounts receivable	1	–	2	–	–	–	5	–	–	–	–	4	–	–
Pension fund accounting	2	2	–	–	–	–	2	3	–	–	8	4	3	–
Any other mentions	30	27	28	29	46	31	24	24	27	11	31	26	38	43
Don't know no answer	5	4	2	6	–	8	7	12	–	33	8	4	6	–

Such elements as qualitative judgments about management capabilities, likely market growth, strategic plans and goals, management observations and insights, product information of a unique nature, and competitive elements that might not be apparent are all cited as important considerations that often are of equal rank to the more traditional quantitative financial information.

Observation: *It is evident from these results that such qualitative factors are going to have to be reckoned with as being at least important in determining the ultimate judgment about companies. They are obviously widely viewed as important and do not appear to be diminishing in importance.*

[HARRIS]

I.6.141

Where the Art of Accounting Is Headed

As in 1980, the 1985 study probed some much discussed possible trends that might be shaping up in accounting practice and financial reporting. In each case, each person interviewed was given a written description of the possible development and then asked how likely it was to take place and then, if the change did take place, would it be positive or negative.

Table 2.6

POSSIBLE DEVELOPMENTS IN THE FUTURE STATE OF THE ART OF ACCOUNTING

	Likely to Take Place		Positive or Negative Development			
	1985	1980	1985		1980	
	%	%	Positive %	Negative %	Positive %	Negative %
Financial reports in the future will give less attention to earnings per share and much more emphasis to components of earnings, such as revenues and operating income.	83	78	82	11	71	19
Return on investment will take over from earnings per share as the key measure of the performance of an enterprise.	69	67	69	17	64	23
As inflation continues, current cost measurements will gradually become more important than historical cost measures, because earnings measures based on current costs will better allow investors to make assessments of the earning powers of enterprises.	68	93	52	39	77	17
Fixed and variable costs will be broken out in financial reporting to show the impact that management decisions have in areas such as maintenance, advertising and other selling expenses, and research and development.	57	67	65	28	60	31
Data such as earnings forecasts will be required in financial reports.	52	68	38	55	36	58
Data such as reporting of responses to social responsibilities will be required in financial reports.	29	48	24	64	23	68

The most likely and most positive potential change that is believed to be taking place is the perceived replacement of earnings per share as the pivotal key to financial reports by components of earnings, such as revenues and operating income. A sizable 83% believe this is likely to happen and a big 82-11% majority would welcome such a change, up from a comparable 71-19% who felt that way in 1980.

The only other scenario that is viewed as more likely now than it was in 1980 is that earnings per share will be replaced by return on investment as the key measure of performance, a move that would be looked on favorably by a 69-17% margin, up slightly from 64-23% who felt that way in 1980.

Observation: *It is evident that earnings per share is fading fast as the key measurement of the success of management of corporations. The most likely replacement, in the view of these key players in the financial community, are reports on components of earnings, such as revenues and operating income. Such a change would be widely welcomed in all sectors.*

[HARRIS]

1.b. 143.

Following is a breakdown by respondents on possible developments in the future state of the art of accounting.

Table 2.7

POSSIBLE FUTURE DEVELOPMENTS: BREAKDOWN BY RESPONDENTS

Q.8A—In the future, how likely is it that the following developments will take place . . . (READ EACH ITEM)?

		Large Public Companies		Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers	C. E. O.	C. E. O.			Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
As inflation continues, current cost measurements will gradually become more important than historical cost measures because earnings measures based on current costs will better allow investors to make assessments of the earning powers of an enterprise														
Highly likely	22	6	13	27	21	39	26	24	27	20	27	10	37	47
Somewhat likely	47	44	37	42	39	44	57	51	47	53	53	61	55	35
Hardly likely	31	50	51	27	39	15	16	22	27	20	20	29	8	18
Not sure	1	–	–	3	–	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Fixed and variable costs will be broken out in financial reporting to show the impact that management decisions have in areas such as maintenance, advertising and other selling expenses, and research and development														
Highly likely	12	1	5	12	4	29	26	4	7	7	–	23	11	12
Somewhat likely	45	35	48	39	46	41	54	40	40	40	40	39	58	59
Hardly likely	42	63	46	45	50	27	20	53	53	47	60	35	32	24
Not sure	1	1	1	3	–	2	–	2	–	7	–	–	–	6
No answer	*	–	–	–	–	–	–	–	–	–	–	3	–	–
Return on investment will take over from earnings per share as the key measure of the performance of an enterprise														
Highly likely	24	23	29	30	25	27	30	9	7	13	7	23	13	29
Somewhat likely	45	49	42	33	54	51	51	36	20	40	47	52	47	18
Hardly likely	30	28	29	33	21	22	18	51	67	40	47	23	37	53
Not sure	1	–	–	3	–	–	2	4	7	7	–	3	3	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Data such as earnings forecasts will be required in financial reports														
Highly likely	9	1	10	3	4	7	10	13	20	13	7	16	13	18
Somewhat likely	43	44	49	33	39	29	43	38	33	47	33	48	58	47
Hardly likely	47	55	41	61	54	61	48	47	47	33	60	35	29	35
Not sure	1	–	–	3	4	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

1.b. 143

Table 2.7 (continued)

POSSIBLE FUTURE DEVELOPMENTS: BREAKDOWN BY RESPONDENTS

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers			Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Data such as reporting of responses to social responsibilities will be required in financial reports														
Highly likely	4	–	5	3	7	7	8	2	–	–	7	–	5	6
Somewhat likely	25	27	29	15	21	34	18	9	7	7	13	19	39	35
Hardly likely	70	73	66	79	68	56	74	87	93	87	80	81	55	59
Not sure	1	–	–	3	4	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Financial reports in the future will give less attention to earnings per share and much more emphasis to components of earnings, such as revenues and operating income														
Highly likely	31	14	25	27	36	37	48	31	33	20	40	55	34	24
Somewhat likely	51	64	47	45	57	49	49	51	53	53	47	32	53	65
Hardly likely	15	21	25	24	7	12	2	11	7	20	7	13	13	12
Not sure	2	1	3	3	–	2	2	7	7	7	7	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

Table 2.8

WHETHER FUTURE DEVELOPMENTS WOULD BE POSITIVE OR NEGATIVE CHANGES: BREAKDOWN BY RESPONDENTS

Q.8B—Would the following be a positive or negative change in the state of the financial reporting art . . . (READ EACH ITEM)?

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers			Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
As inflation continues, current cost measurements will gradually become more important than historical cost measures because earnings measures based on current costs will better allow investors to make assessments of the earning powers of enterprises														
Positive change	52	29	30	55	57	66	82	44	40	40	53	45	82	76
Negative change	39	63	58	36	39	24	16	44	47	40	47	45	5	12
No change	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Not sure	8	5	10	9	4	10	–	11	13	20	–	10	13	12
No answer	1	3	1	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

1.6.144

Table 2.8 (continued)

WHETHER FUTURE DEVELOPMENTS WOULD BE POSITIVE OR NEGATIVE CHANGES: BREAKDOWN BY RESPONDENTS

		Large Public Companies		Small Public Companies	Private Companies			Large Accounting Firms						
	Total	Chief Executive Officers	Chief Financial Officers	C. E. O.	C. E. O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Fixed and variable costs will be broken out in financial reporting to show the impact that management decisions have in areas such as maintenance, advertising and other selling expenses, and research and development														
Positive change	65	50	53	45	54	76	93	62	60	67	60	61	79	94
Negative change	28	44	41	39	25	20	7	29	27	27	33	29	11	6
No change	*	–	–	–	–	–	–	2	7	–	–	–	–	–
Not sure	7	5	5	15	21	5	–	7	7	7	7	6	11	–
No answer	1	1	1	–	–	–	–	–	–	–	–	3	–	–
Return on investment will take over from earnings per share as the key measure of the performance of an enterprise														
Positive change	69	76	72	67	86	71	75	58	47	53	73	74	47	53
Negative change	17	12	15	27	7	22	8	27	33	27	20	13	24	35
No change	1	1	1	–	–	–	–	–	–	–	–	–	3	–
Not sure	12	10	10	3	7	7	16	16	20	20	7	13	26	12
No answer	1	1	1	3	–	–	–	–	–	–	–	–	–	–
Data such as earnings forecasts will be required in financial reports														
Positive change	38	19	25	33	25	32	51	51	60	33	60	52	66	65
Negative change	55	73	71	67	71	61	38	44	40	60	33	42	24	24
No change	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Not sure	6	6	3	–	4	7	11	4	–	7	7	6	11	12
No answer	*	1	1	–	–	–	–	–	–	–	–	–	–	–
Data such as reporting of responses to social responsibilities will be required in financial reports														
Positive change	24	26	22	18	29	24	21	20	20	20	20	16	37	24
Negative change	64	64	67	79	64	56	64	64	60	60	73	74	37	71
No change	1	–	–	–	–	–	2	2	7	–	–	–	3	–
Not sure	11	8	10	3	7	17	13	13	13	20	7	10	24	6
No answer	1	3	1	–	–	2	–	–	–	–	–	–	–	–
Financial reports in the future will give less attention to earnings per share and much more emphasis to components of earnings, such as revenues and operating income														
Positive change	82	74	70	76	86	80	98	89	80	87	100	84	82	94
Negative change	11	14	19	21	–	10	–	4	13	–	–	13	11	6
No change	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Not sure	7	10	10	3	14	10	2	7	7	13	–	3	8	–
No answer	*	1	1	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

1(c). Investors' and Creditors' Use of Information to Achieve Their Objectives

Review of the Summary of Robert Morris Observations on the Uses of Financial Information: All banker participants felt as if [the] one page summary was a fair representation of our views on the matters discussed [at the March 11, 1992 meeting with the AICPA Special Committee. The summary follows: **[RMA92, p. 13]**

- Financial statements are the beginning point for answering "How will the Company repay us?"

- Financial statements would be easier to use in computer readable diskette format because its makes analysts' rearrangement of information easier to apply.

- Direct Method formats of cash flows are more useful than indirect method. Most bankers convert indirect to direct data as best as they can.

- Information disaggregated by product/line of business is needed to analyze payback ability.

- One year cash budgets are frequently requested by lenders to gain understanding they believe would have been derivable from historical (cash flow) statements if such statements had been disaggregated by product line or other division. Financial statements would be more useful to bankers if the statements presented disaggregated cash flow information on a historical basis and also, perhaps include a one year cash flow forecast.

- Market value information on assets has low interest because operating cash flows are considered the primary source of repayment, not the asset. Asset values are looked at from orderly liquidation of business viewpoint and then only to assess risk if the primary source fails. Historical cost regarding long-lived assets is used to evaluate equipment age and need for reinvestment capital.

- Historical cost is not considered to need replacement by fair value. In particular, discounted cash flow is seen as too dependent on subjective judgements to provide the three to five year comparability and consistency needed for credit analysis. Other valuation methods are also observed to be too subjective in comparison to historical cost. Moreover the focus on cash flow makes "value of assets" a secondary concern of risk assessment.

- Disclosure of claims on cash is important in a wide range of disclosures from current liability classification to FAS 87 pension disclosures.

- RMA believes financial statements should reflect the borrowers' judgement within the framework of consistently applied generally accepted accounting principles. Non-GAAP presentations introduce other types of "judgement" differences in financial data that are difficult to "filter" and analyze.

- Along with disaggregated information, better ways to highlight unusual or infrequent items would help credit analysts.] **[RMA 92, p. 1]**

FAS 106 requires employers to account for their retiree welfare benefit liabilities on an accrual, rather than "pay-as-you-go" basis. Although accrual accounting doesn't "create" costs, it does require companies to recognize and disclose *future* benefit payments in their current financial statements. And for a typical company, annual FAS 106 costs will be about six times greater than pay-as-you-go costs. **[TOWERS PERRIN, p. 1]**

Nevertheless, some observers have argued that investment professionals will generally ignore FAS 106 because the new accrual accounting standard has no effect on a company's current cash flows. Most of the survey respondents, however, take a different view. Just under two-thirds (63%) believe that FAS 106 liabilities represent a significant future cash cost that should be reflected in current equity valuations. [Also included in 1(b)] **[TOWERS PERRIN, p. 2]**

The survey participants . . . disagree with the notion that FAS 106 will have a "uniform" impact on all companies and, thus, can be generally discounted. Fully 71% of the group believe that comparable companies will show substantially different FAS 106 costs. **[TOWERS PERRIN, p. 2]**

A Towers Perrin analysis of 1991 retiree welfare valuation data supports this view. In this analysis, annual FAS 106 costs for a 147-company sample range from $428 to $9,230 per active employee. Similarly, in a Towers Perrin survey conducted earlier this year, a group of 150 employers reported FAS 106 reductions in pretax earnings ranging from less than 5% to 30% or more. The average earnings reduction for this group was 17%. [Footnote references omitted.] **[TOWERS PERRIN, p. 2]**

While some observers argue that the financial community has fully anticipated the effects of FAS 106, the survey respondents generally agree that a complete reckoning won't come until after the adoption deadline. (Most companies must adopt the standard by the first quarter of 1993.) Moreover, just over half of the survey respondents (51%) say that "surprises" will be common—because market expectations are based on incomplete information and do not anticipate variations in individual company results. **[TOWERS PERRIN, p. 2]**

Experience with companies that have adopted FAS 106 in advance of the deadline corroborates that view. In 1991, for example, both IBM and GE announced onetime FAS 106 charges in excess of $2 billion. Although significant, these figures were *lower* than expected—largely as a result of factors that are not normally disclosed in public documents or are up to management discretion. **[TOWERS PERRIN, p. 2]**

More than two-thirds (69%) of the survey group say that a company's stock price would decline if reported FAS 106 expense were higher than expected. Although many of the respondents are reserving judgment about specific price effects until they have full information on FAS 106 costs, more than half (55%) did offer predictions. **[TOWERS PERRIN, p. 3]**

These investments professionals say, on average, that a company's stock price would drop 6% if its reported reduction in the earnings were 10% greater than expected. Their predictions for price reductions in this hypothetical case range from 1% to 20%. More than a third (35%) anticipate price declines of 10% or more. **[TOWERS PERRIN, p. 3]**

Not surprisingly, more equity experts are concerned about the impact on earnings than the effect on net worth. Just over half (51%) said a company's stock price would drop if its reported FAS 106 liability, as a percentage of net worth, were 10% higher than anticipated. Interestingly, however, the money managers--who purchase equities on behalf of major institutions (including pension funds)--are more sensitive to net worth: 56% of this group say stock prices would be affected by unexpectedly large reductions in net worth, while only 46% of the broker group say prices would be affected. **[TOWERS PERRIN, p. 3]**

According to the survey, the decision employers make about how--and when--to adopt the new accounting standard will not go unnoticed in the investment community. In general, the survey respondents tend to favor conservative FAS 106 expensing strategies. . . .For example, about half (51%) say the markets will view early adoption favorably. Clearly, early adoption gets the problem out of the way--and gives the investment professionals the information they want about a company's liabilities and expense. [Also included in 1(b)] **[TOWERS PERRIN, p. 3]**

Similarly, many of the survey respondents (47%) express a positive view of companies that take the transition obligation for past employee service as a onetime "hit," rather than amortizing it. This finding supports the view that investors might be inclined to discount a large onetime charge, particularly because this approach reduces future expense. (For a typical company, taking the hit up front would reduce future annual expense by about 30% and allow the company to show earnings from continuing operations that are more than 10% higher.) [Also included in 1(b)] **[TOWERS PERRIN, p. 3-4]**

Notably, over half (56%) of the survey respondents say "conservative" (i.e., higher than average) medical trend assumptions will be viewed positively. This finding suggests that, although conservative assumptions will tend to depress earnings initially, investment professionals would rather see a company report the "worse case" at the outset--so that future expense revisions, if any, would take a downward rather than upward direction. [Also included in 1(b)] **[TOWERS PERRIN, p. 4]**

Interestingly, the <u>money managers</u> in the survey group express slightly stronger opinions about expensing strategy. Well over half (59%) say they view early adoption favorably, while only 42% of the broker group shared that opinion. The money managers are also more positive about conservative medical trend assumptions: 64% express a favorable view of higher-than-average assumptions, while 52% of the broker group take that view. (The two groups offer similar opinions about companies that take the transition charge up front.) [Also included in 1(b)] **[TOWERS PERRIN, p. 4]**

While the equity experts are clearly concerned about bottom line numbers, the [FAS 106] survey results show that the <u>*actions* employers take</u> to control future costs--i.e., <u>benefit design</u>

and funding strategies—will also have an impact on the investment community's assessment of a company's financial position. [Also included in 1(b)] **[TOWERS PERRIN, p. 4]**

Specifically, the survey group strongly favors caps on future expenditures—such as a "defined dollar benefit" designed to protect the company against the effects of inflation. Fully 81% say caps would have a positive impact on the way the markets view a company's financial position. Most of the survey respondents (65%) also view funding positively, despite the fact that this strategy reduces corporate cash available for investment (or for shareholders in the event of bankruptcy). **[TOWERS PERRIN, p. 4]**

It's worth noting that, in the Towers Perrin employer survey, 18% of respondents had imposed caps on company contributions for future retirees and 7% had taken that approach for current retirees. An additional 29% were planning or considering caps for future retirees. Very few (under 10%) were funding their benefit liabilities at the time. Employer efforts to redefine benefit design and funding strategies have, however, increased in recent months and are likely to continue as more companies confront their FAS 106 costs. **[TOWERS PERRIN, p. 4-5]**

Most equity experts recognize that full information on FAS 106 costs won't be available until all companies adopt the new standard during the first quarter of 1993. In the meantime, however, more than three-quarters of the survey respondents (77%) say their firms' equity valuation analyses include an examination of a company's footnoted retiree welfare disclosures. (These disclosures are required by the SEC for annual reports and other financial statements.) [Also included in 1(b)] **[TOWERS PERRIN, p. 5]**

Moreover, many of the survey respondents (62%) currently factor in some estimate of FAS 106 costs when preparing equity valuations, earnings forecast, buy/sell/hold recommendations and other analyses for clients. Among those who do factor in FAS 106 costs, more than half (57%) include some sort of *explicit* analysis. **[TOWERS PERRIN, p. 5]**

For example, about a third (34%) of those who factor in retiree welfare costs note FAS 106 expense estimates in their equity research reports. More than a quarter (27%) make explicit distinctions between companies that recognize the past service obligation and those that amortize it. Just under 20% say they make specific reference to FAS 106 costs in other ways (such as a before/after analysis). Some of the respondents use more than one of these approaches. **[TOWERS PERRIN, p. 5]**

Only about a quarter of the survey respondents (26%) say they use benchmarks in their efforts to estimate the impact of FAS 106. Of those who do use benchmarks, just under half (49%) say they develop liability and/or expense estimates based on a benchmark multiple of current pay-as-you-go costs. Fewer use benchmark reductions in pretax earnings or net worth (28% and 32%, respectively). [Also included in 1(b)] **[TOWERS PERRIN, p. 6]**

[Regarding adoption of FAS 106] in preparing analyses for a specific company, many of the survey respondents (58%) make adjustments for certain company-specific factors. Most of these equity experts say they look at employee demographics (71%), whether the workforce is unionized (62%) and the nature of the benefit plan (52%). . . .Notably, the brokers in the group look more closely at employee demographics and the benefit plan than the money

managers do. Fully 80% of the brokers cite employee demographics as a factor, while 57% of the money managers do; 61% of the brokers say they look at the nature of the benefit plan, while 38% of the money managers cite the plan as a factor. [Also included in 1(b) and 13] **[TOWERS PERRIN, p. 6]**

The diverse opinions expressed by the survey group on some issues are understandable for a number of reasons—not the least of which is the FAS 106 information gap. Retiree welfare costs are largely determined by factors that are not normally disclosed to the public. And relatively few employers began to report their FAS 106 data until this year—in 1991 annual reports, for example. [Also included in 16(b)] **[TOWERS PERRIN, p. 7]**

Moreover, those data are *preliminary* in most cases. One reason is the fact that management discretion—in developing expensing, benefit and funding strategies—plays a critical role in determining the magnitude of FAS 106 expense. So although FAS 106 is an "objective" standard, it's difficult to anticipate how much of a difference changing conditions would make between preliminary and final results for individual companies. It's also unlikely that any two companies will take exactly the same approach to managing costs. [Also included in 16(b)] **[TOWERS PERRIN, p. 7]**

Given these factors, it's not surprising that 69% of the survey group say that management efforts to communicate with the investment community about FAS 106 issues will have a positive impact on assessments of a company's financial position. . . .Employers might therefore want to include investor communications in their FAS 106 adoption plans. [Also included in 16(b)] **[TOWERS PERRIN, p. 7]**

Another factor is that FAS 106 is uncharted territory for most equity experts. Treatment of nonrecurring "events" (such as dividend cuts, earnings reductions) and other past experiences (such as FAS 87), although similar in some ways, haven't fully prepared investment professionals for the complexity they face in evaluating retiree welfare benefits costs. [Also included in 16(b)] **[TOWERS PERRIN, p. 7]**

Whether FAS 106 will have an impact on corporate credit ratings and borrowing capacity remains to be seen. Credit ratings are based primarily on cash flow and financial flexibility. And since neither will be directly affected by FAS 106, the rating agencies are generally inclined to view the new accounting standard as a "nonevent"—at least as far as specific ratings go. [Also included in 1(b)] **[TOWERS PERRIN, p. 8]**

In a report released last year, for example, Standard & Poor's (S&P) said that FAS 106 "is not expected to have any widespread impact on debt ratings, since cash flow will not be affected directly." Moody's has also stated that "rating changes are not anticipated" as a result of FAS 106, because "this liability has been factored into our ratings." Moreover, <u>some credit analysts believe that FAS 106 may have *positive* credit implications for some companies, because it encourages them to limit generous retiree medical benefit plans</u>. [Footnote references omitted.] [Also included in 1(b)] **[TOWERS PERRIN, p. 8]**

Nevertheless, the rating agencies indicate that they will look more closely at retiree welfare liabilities as a result of FAS 106. Moody's says that FAS 106 "will clearly impact the

reported financial statements of some companies more than others," and that it "will review carefully the assumptions underlying the numbers." Similarly, S&P says that retiree welfare obligations "represent a substantial and growing burden for many companies" and will therefore subject those liabilities to greater scrutiny. [Also included in 1(b)] **[TOWERS PERRIN, p. 8]**

Other market observers believe that companies considered "marginal credits" will feel the effects of FAS 106 more than others. Even without a rating downgrade, "increases in reported retiree medical expenses and the disclosure of the cumulative liability may impair market access and cause new issue borrowing spreads to widen" for these companies. These analysts also expect that some companies may violate net worth or leverage covenants in existing debt agreements as a result of FAS 106. But because issuers are likely to factor FAS 106 into future covenant negotiations, future borrowings may not be affected. [Footnote references omitted.] [Also included in 1(b)] **[TOWERS PERRIN, p. 8]**

Clearly, employers shouldn't expect institutional analysts and investors to overlook the effects of FAS 106. The Towers Perrin survey shows that, despite the temporary information gap, many investment professionals are paying close attention to retiree welfare liabilities and how companies manage them. In fact, a significant percentage of the survey respondents (47%) say that a company's ability to manage retiree benefit costs is a strong indicator of *overall* management effectiveness. [Also included in 1(c)] **[TOWERS PERRIN, p. 8]**

Especially critical are the specific strategies companies develop for managing expense and controlling future costs. While the survey demonstrates that earnings from continuing operations is still the most closely watched indicator of corporate performance, equity experts are also influenced by qualitative factors—including management's approach to valuation assumptions, timing, benefit design and funding. [Also included in 1(b)] **[TOWERS PERRIN, p. 8]**

The survey results clearly indicate that employers should consider investor expectations when they're making FAS 106 decisions. Expensing strategy is a good example. Following is a closer look at the issues. [Also included in 1(b)] **[TOWERS PERRIN, p. 8]**

- Assumptions. FAS 106 allows employers to develop "best estimates" for key expense variables such as interest rates, expected retirement ages and health care cost "trend" (the rate of increase in per capita health care prices and usage). Assumption decisions can, in turn, have a significant impact on the charge against earnings. For example, if a typical manufacturing company lowered its long-term health care trend assumption by 2%, FAS 106 expense would drop by as much as 30%. [Also included in 1(b)] **[TOWERS PERRIN, p. 9]**

- What's the best approach? The investment community won't look favorably on an unexpectedly large expense—either initially, or later if upward revisions become necessary. Many equity experts probably favor conservative assumptions for that reason. On the other hand, minimizing expense is clearly important. [Also included in 1(b)] **[TOWERS PERRIN, p. 9]**

- So the key is to strike a reasonable balance--i.e., an approach that avoids overstating or understating expense. In any case, a company's FAS 106 assumptions, whether conservative or aggressive, should be consistent with management's general approach to financial reporting. [Also included in 1(b)] **[TOWERS PERRIN, p. 9]**

- **Taking the transition 'hit.'** As the survey results show, most investment professionals are more concerned about earnings reductions than reductions in net worth, and many would be inclined to discount large onetime charges. And since charging the transition obligation up front substantially reduces the FAS 106 impact on future earnings, most companies will take that approach if they can afford it--i.e., if net worth is sufficient to absorb the onetime charge. (Those whose initial liability amounts to less than 50% of net worth will generally choose to take the charge.) [Also included in 1(b)] **[TOWERS PERRIN, p. 9]**

While 55 percent of the individual sample find annual reports useful to investment decisions, individuals gave annual reports a low rating as a source of information on buying and selling stock -- ranking them next to last among seven information sources. [Also included in 1(b)] [HILL KNOWLTON, p. 7]

INDIVIDUAL INVESTOR[S'] VIEWS ON THE USEFULNESS OF VARIOUS TYPES OF INFORMATION]

- **For [the statement below], would you say that you agree or disagree with it?**

Annual reports are useful to me in making investment decisions.

Results in percentages

	TOTAL
AGREE	**54.7**
DISAGREE	**34.4**
DON'T KNOW/NO ANSWER	**10.9**
TOTAL	**100.0**

[HILL KNOWLTON, TABLE 13]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Stockbrokers' recommendations] for providing information on buying or selling a stock.**

Results in percentages

	TOTAL
A NOT AT ALL IMPORTANT SOURCE	27.9
SOMEWHAT IMPORTANT	24.7
A VERY IMPORTANT SOURCE	45.3
DON'T KNOW/NO ANSWER	2.0
TOTAL	99.9

[HILL KNOWLTON, TABLE 14]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Friends'/relatives' recommendations] for providing information on buying or selling a stock.**

Results in percentages

	TOTAL
A NOT AT ALL IMPORTANT SOURCE	48.2
SOMEWHAT IMPORTANT	34.0
A VERY IMPORTANT SOURCE	15.4
DON'T KNOW/NO ANSWER	2.4
TOTAL	100.0

[HILL KNOWLTON, TABLE 15]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Articles in the press] for providing information on buying or selling a stock.**

Results in percentages

TOTAL

A NOT AT ALL IMPORTANT SOURCE	17.8
SOMEWHAT IMPORTANT	38.1
A VERY IMPORTANT SOURCE	41.3
DON'T KNOW/NO ANSWER	2.8
TOTAL	100.0

[HILL KNOWLTON, TABLE 16]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Annual reports] each source for providing information on buying or selling a stock.**

Results in percentages

	TOTAL
A NOT AT ALL IMPORTANT SOURCE	29.1
SOMEWHAT IMPORTANT	40.9
A VERY IMPORTANT SOURCE	25.1
DON'T KNOW/NO ANSWER	4.9
TOTAL	100.0

[HILL KNOWLTON, TABLE 17]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Business programs on radio and television] for providing information on buying or selling a stock.**

Results in percentages

	TOTAL
A NOT AT ALL IMPORTANT SOURCE	22.7
SOMEWHAT IMPORTANT	38.5
A VERY IMPORTANT	

SOURCE	34.8
DON'T KNOW/NO ANSWER	4.0
TOTAL	100.0

[HILL KNOWLTON, TABLE 18]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Statistical services, such as S&P and Value Line] for providing information on buying or selling a stock.**

Results in percentages

	TOTAL
A NOT AT ALL IMPORTANT SOURCE	11.7
SOMEWHAT IMPORTANT	20.6
A VERY IMPORTANT SOURCE	62.3
DON'T KNOW/NO ANSWER	5.3
TOTAL	99.9

[HILL KNOWLTON, TABLE 19]

- **Using a 0-to-10 scale, with 0 being a not at all important source and 10 being a very important source, please indicate how you would rate [Your own analysis of stocks as an investment] for providing information on buying or selling a stock.**

Results in percentages

	TOTAL
A NOT AT ALL IMPORTANT SOURCE	8.1
SOMEWHAT IMPORTANT	14.6
A VERY IMPORTANT SOURCE	72.1
DON'T KNOW/NO ANSWER	5.3
	100.1

[HILL KNOWLTON, TABLE 20]

Virtually all investors want unbiased, candid, unembellished investment information. They do not want sales pitches from brokers, optimistic expectations (or self-serving excuses) from company management, or information distorted by inappropriate interpretation and analysis. Most investors, especially the professionals and the semiprofessional individual investors, think that they can spot biases; some believe that they can filter out the biases to reach some degree of objectivity. If they cannot eliminate the biases for themselves, they place high value on information sources that can do so, either analytically or based on experienced judgment. [Also included in 1(a)] **[SRI, p. 34-35]**

Not only is the annual report one of the most readily available of sources, and certainly a low-cost source to users, but it has the most nearly comprehensive coverage of the types of information most needed by investors. Yet, the annual report has no role in the securities purchase decisions of most individual investors, and only a limited role in the decision to sell securities. It serves primarily as a reference document and, for many, a source of reassurance about their investments. Individual investors rarely even see the annual report until after they own a company's securities. The report is somewhat more important for the semiprofessional individual investors, whose analytical decision-making styles draw from data and financial information found in the annual. [Also included in 1(b)] **[SRI, p. 51]**

Professional investors are influenced to a greater degree by the annual report, although it still ranks only fifth in its importance to them. As with the individuals, the annual report is the most used source but not the most useful source. Virtually all professionals state that they always obtain both the annual report and SEC Form 10K prior to making investment decisions. Professionals complain, however, that companies often provide professionals with annual reports, but not with 10Ks--a careless omission in their view. [Also included in 1(b)] **[SRI, p. 51]**

Professionals discard about one-third of the annual reports they receive. Those they keep they use as reference sources for analysis and report writing. On average, each professional receives 324 annual reports per year, with sell-side analysts receiving 439, the buy-side professionals 343, and the brokers 187. [Also included in 1(b)] **[SRI, p. 51]**

Very few investors read the entire annual report when they receive it, although professionals eventually read all the annual reports on companies they follow. Reading patterns are highly selective, either focused and directed in the case of sophisticated investors who know the information they want and who specifically seek it out in the annual, or less focused for those who go through the report more casually, reading in depth those items that attract their interest. When asked what they do with annual reports when they arrive, investors provided the responses shown [below]. [Also included in 1(b)] **[SRI, p. 52]**

Reading the Annual Report

Action	*Individual Investors*	*Professional Investors*
Throw it away without reading it	3.9%	(not asked)
File it or save it without reading it	3.0	9.4%
Skim the whole report to get a general impression of the company	27.0	21.7
Glance through it, stopping to read what attracts attention	34.5	29.8
Seek out specific items of information	22.7	33.4
Read the entire report	8.6	5.0

Note: Findings are based on responses to the question, "Which of the following statements most nearly describes the way you read an annual report when you first receive it?"
Source: SRI International survey, 1986. [Also included in 1(b)] **[SRI, p. 52]**

"Reading," to most individuals, seems to include casually looking over the material and drawing some meaning, however, small, from it. To the professionals, reading means going through all the material and paying close attention to it. What the professionals call reading, the individuals might call studying. [Also included in 1(b)] **[SRI, p. 52-53]**

Professionals read annual reports in two different ways and at different times. When they first receive annual reports they glance through them, reading a few items of interest; then they either discard the reports or keep them for future reference. Later, the annual reports that were retained are read and analyzed in considerable detail. [Also included in 1(b)] **[SRI, p. 53]**

Individual investors are not nearly as aware of the various parts of the annual report as are the professionals. Individuals tend to think in terms of the front and the back of the annual. The front, consisting of the narrative part of the report, is generally understandable, although not always useful or interesting. The back, consisting of "the numbers," is generally considered important, but not very comprehensible. While not always familiar with specific parts of the annual, individuals have formed opinions on their importance for decision making. The professionals, on the other hand, discriminate easily among the various parts of the annual and find them all understandable. [Also included in 1(b)] **[SRI, p. 53]**

[The] table [below] shows the importance of various parts of the annual report to both individuals and professionals. Being selective in their reading patterns, professionals focus on those parts of the annual report providing the most relevant information. In virtually all instances, the professionals read the financial statements and the footnotes, while paying varying amounts of attention to the other sections. [Also included in 1(b)] **[SRI, p. 53]**

Individuals often recognize the importance of sections they might not fully understand and value what little meaning they can extract from those sections. For that reason, even the many individuals who profess not to understand much of the income statement, for instance, place high importance on that statement. Furthermore, they seek interpretation about the company's

earnings stream from the other information sources they use and from advisors whose competence they trust. [Also included in 1(b)] **[SRI, p. 53]**

Somewhat surprisingly, individual investors rate the financial statements as more important than the narrative, less quantitative parts of the [annual] report, for several reasons. Primarily, of course, is the fact that financial performance is most clearly stated in numerical terms--a few simple terms for unsophisticated investors, plus numerous complex and abstract terms for sophisticated investors. For all their variation and occasional inaccuracy, numbers convey an impression of precision and clarity. The narrative parts of the annual report convey less precision, give more latitude for interpretation by the reader, and allow more room for manipulation by the writer. Importantly, the numbers in the annual report are known to be more closely reviewed by outsiders, specifically, the CPA firm conducting the audit and presenting its findings in the auditor's opinion included in each annual report. In addition, the SEC requires annual reports and other corporate communications to meet certain standards of disclosure. Finally, virtually all investors understand that financial statements are governed, however imperfectly, by accounting principles and conventions. None of these disciplines is believed to be infallible, but few comparable disciplines are applied to the narrative parts of the annual report; hence, the narrative portions are felt to be less reliable sources of information. [Also included in 1(b) and 13] **[SRI, p. 53&55]**

Importance of Annual Report Sections

	Individual Investors			*Professional Investors*	
	Percent Who Read This Section	*Percent of Users Rating Important or Extremely Important*	*Rank*	*Percent of Users Rating Important or Extremely Important*	*Rank*
Income statement	84.9%	78.6%	1	94.2%	1
Balance sheet	82.1	75.0	2	90.1	2
Footnotes to financial statements	51.4	42.9	8	80.4	3
Sources and uses of funds	74.6	72.7	3	76.3	4
Historical operating results	70.3	46.2	7	69.6	5
Quarterly reports	65.5	39.7	9	68.3	6
Financial highlights	82.3	57.2	4	65.7	7
Divisional or business segment reviews	56.6	55.3	5	63.1	8
Management's review	76.1	51.1	6	56.7	9
Chairman's/president's letter	77.8	31.4	12	45.8	10
General company and product information	63.5	33.3	11	44.9	11
Auditor's/CPA's opinion	55.6	34.9	10	39.4	12
List of officers and directors	59.4	19.8	13	19.2	13

Source: SRI International survey, 1986. [Also included in 1(b)] **[SRI, p. 54]**

In their use of annual reports, semiprofessional individual investors behave more nearly like the professionals than like the other investors. They generally score all parts of the annual higher, and their importance ratings reflect a pattern similar to that of the professional analysts. [Also included in 1(b)] **[SRI, p. 55]**

The four lowest ranked parts of the annual report are the same for both professionals and individuals. These are the chairman's/president's letter, general company and product information, the auditor's/CPA's opinion, and the officer and director information. [Also included in 1(b), 13, and 17(f)] **[SRI, p. 55]**

Issuers of annual reports inaccurately stress the importance of the chairman's/president's letter. Annual report issuers consider the chairman's/president's letter to be the most important part of the annual report, especially for individual investors. Investors themselves, however, tell us

that while they frequently read the CEO's letter, they rarely consider it important for decision making. [Also included in 1(b)] **[SRI, p. 55]**

Most individual investors do not know much about footnotes; many find them arcane and undecipherable. Even so, a slight majority (51.4 percent of those receiving annual reports) do "read" them. The only segment of individuals to ascribe a high level of importance to footnotes is the semiprofessional segment; 68.5 percent of them read the footnotes, and of those 60.0 percent consider them important. Furthermore, only about a quarter of all individual investors agree with the statement. "I have to read the footnotes to the financial statements to get an accurate picture of a company's performance" nearly half of the semiprofessionals agree with that statement. [Also included in 1(b)] **[SRI, p. 55]**

Professional investors, of course, are much much more knowledgeable about and place greater importance on footnotes. Most agreed with the statement, "I have to read the footnotes to the financial statements to get an accurate picture of a company's performance" (only 8.7 percent disagreed). Their ranking of footnotes as the third most important part of the annual report puts footnotes only behind the financial statements they explain, the income statement, and the balance sheet. [Also included in 1(b)] **[SRI, p. 55-56]**

Professional investors use annual reports for a variety of purposes in addition to investment analysis. Annual report issuers are certainly correct in their perception that annual reports are broadly based publications with many potential uses. [The] table [below] shows the degree to which the various types of professional investors use annuals for different purposes. All professionals use annuals as background and reference information. The brokers are more likely to use them in selling situations, while sell-side analysts and buy-side professionals are more likely to use them for analytical purposes. **[SRI, p. 56-57]**

Uses for Annual Report

Uses	*Total*	*Sell-Side Analysts*	*Buy-Side Professionals*	*Retail Brokers*	*Inst. Sales*
General reference	96.2%	99.0%	92.4%	98.0%	98.0%
Background information prior to meeting with company management	88.5	97.0	90.7	68.0	87.0
Verifying information from other sources	83.0	87.0	79.7	80.0	88.0
Preparing forecasts	76.6	96.0	70.3	58.0	68.0
Selling/discussing with customers	57.1	64.0	28.8	78.0	86.0
Industry analysis and tracking	51.6	76.0	39.8	30.0	52.0
Making presentations to company management	44.6	46.0	45.8	32.0	54.0

Source: SRI International Survey, 1986. **[SRI, p. 56]**

Financial reports are important but not dominant providers of fundamental information [for sell-side analysts.] Discussions with management seem to user a most important source of information for analysts, although somewhat underplayed by them. Some analysts reports largely are transcriptions or summaries of a management presentation. One analyst reported on a "conference call" to discuss earnings with management and other analysts. Another reported on presentations and discussions at a company's annual meeting. [Also included in 1(b)] **[PREVITS, p. 11]**

[S]ell-side analysts may be more subtle in their signaling. There are a variety of types of buy and hold recommendations, and analysts may qualify their recommendation in the text of the report. This provides the basis for a relative ranking of companies such that, given that investor resources are not unlimited, weak hold recommendations can be viewed as sell signals. A few analysts reports are more general evaluations that do not contain specific recommendations. [Also included in 1(a)] **[PREVITS, p. 11-12]**

In assessing individual company's performance over time, analysts speak of "easy" and "hard" earnings comparisons with earlier equivalents periods. Analysts show awareness of earnings management, for example in commenting on the easy earnings comparison of a company occasioned by a "big bath" taken in the year earlier period. They are particularly interested in identifying company trends and changes affecting company trends. Directional phrases such as "change(s)", "increase", "decrease", "decline", "new", and so forth, occur thousands of times in the full sample [of the study]. [Also included in 1(a)] **[PREVITS, p. 12]**

[Sell-side] analysts often organize their reports so as to provide information that supports their EPS forecasts but also provide a list of "risks" or "concerns" that could negatively affect a company's performance. Corporate auditors are identified or commented upon infrequently [in analysts reports], however in one instance a change in auditors was listed as a "risk factor". [Also included in 1(a), 10(d), and partly included in 17(f)] **[PREVITS, p. 12]**

A standard, if somewhat simplified, approach taken by most analysts in forming recommendations is as follows. Disaggregate the company's operations into as fine a set of operating units as possible and develop earnings forecasts for each unit. This reduction is much finer than GAAP. For example one report commented that a company "reports two lines, but there are actually three". Analysts regularly discuss the above matters with respect to each operating unit. For example, one waste removal company was analyzed by individual landfills; a gaming company was analyzed by individual casinos, etc. [Also included in 1(a), 1(b), and 3(e)] **[PREVITS, p. 12]**

Analysts aggregate [a variety of information] forecasts to form a company EPS forecast and to determine an appropriate price earnings ratio based upon the company's earnings momentum, growth prospects, earnings quality and stability, financial strength, and other factors. They then compute the product of the EPS forecast and the PE radio. If the current price is below the forecast price, they may recommend "buy"; if near a forecasted price they recommend "hold"; if above a forecasted price, they recommend "sell". The update of a recommendation may be precipitated by a change in management, a divestiture or acquisition or similar 8K event, or by the quarterly or more timely identification of reliable relevant factors. **[PREVITS, p. 12]**

[Sell-side] analysts may not believe that investors have lengthy horizons in assessing company performance. One analyst, for instance, stated: "We continue to rate these shares as neutral,. . . in the belief that investors are not yet ready to discount earnings growth 24 months in the future." [Also included in 1(d)] **[PREVITS, p. 12]**

Analysts tend to employ annualized data but [it is inferred] that they prefer more timely data whenever available. They employ a "rolling" four quarter analysis to annualize data as soon as the new quarterly data appears. Whether or not the issues related to so-called "4th quarter adjustments" taken at fiscal year end are properly anticipated is not clear. [Also included in 1(b) and 11(e)] **[PREVITS, p. 12-13]**

The effect of product changes or new products, even when not yet marketed, are almost always assessed [by sell-side analysts], particularly as to the company's ability to compete, and upon competing products, projected demand, revenue, and costs. [Also included in 1(b) and 13] **[PREVITS, p. 14]**

Major projects, including modernization, acquisition, expansion, divestiture, and restructuring plans are evaluated [by sell-side analysts], and their estimated effects are also used in forecasting future performance. Major expenditures on plant, property and equipment are evaluated, particularly in terms of product costing and capacity expansion. Downsizing plans, and plans to reduce the size of the labor force, are also addressed by the analysts. Analysts also report on the effect of share repurchase plans and planned issuances of new securities. [Also included in 1(b) and 13] **[PREVITS, p. 14]**

Phrases which focus on acquisition occur about 1,500 times in [sell-side analysts'] equity reports studied. Acquisitions are studied in several pro forma dimensions, including earnings and cash flow effects of financing the acquisition, the strategic fit, scale economics, and earnings contribution. [Also included in 1(b) and 13] **[PREVITS, p. 14]**

Finally, analysts use recent and proposed PP&E expenditure levels as a measure of the quality of the company's assets. They evaluate the effect of new contracts (particularly long term) and licensing agreements on EPS. [Also included in 1(b) and 13] **[PREVITS, p. 14]**

[Equity sell-side analysts'] attention . . . is given to revenue change, particularly as a result of product pricing, volume, and demand, and product mix. Production and sale volume information is analyzed. Expenses are only analyzed at a general level usually in terms of "margins", (c.4,200 times), or less frequently in terms of "operating costs", or "SG&A expenses." [Also included in 1(b) and 13] **[PREVITS, p. 15]**

[Equity sell-side analysts give] more detailed attention to noncapital expenditures sometimes . . . in the areas of research and developments expenditures, depreciation, materials and labor. Consistent with their general approach, analysts often estimate expenses by operating unit (segment) and sources of possible cost efficiencies are noted. Relative cost levels are compared across companies and management efforts to reduce costs are noted and evaluated. [Also included in 1(b) and 13] **[PREVITS, p. 15]**

Most [equity sell-side analysts] reports contain both historical and forecast quarterly and annual income statements or summary information. The most common approach to estimating future EPS is to disaggregate the company into its constituent LOB's and/or geographic regions (both of which are frequently more detailed than GAAP requires), and to then develop forecasts of the performance of individual units which are reaggregated for a company EPS estimate. [Also included in 1(b), 3(b), and 11(e)] **[PREVITS, p. 15]**

[O]perating revenues and expenses are often assessed [by equity sell-side analysts] for individual segments of a company. Performance analysis by significant product or individual location is common. For example, analysts may evaluate the performance of hotel companies in terms of specific U.S. or international geographic regions, or even specific hotels, while mining companies are evaluated in terms of individual mines. Similarly, consumer goods manufacturers are often evaluated in terms of their individual product lines or products. Some analysts carefully consider the effect on the entire company, industry, and economy as well as revenues and costs in forecasting the results for each reporting unit analyzed. [Also included in 1(b) and 3(e)] **[PREVITS, p. 15]**

A principal approach of many [equity sell-side] analysts for estimating a company's earnings per share involves the disaggregation of the company into as fine a set of reporting units as possible, followed by an earnings analysis and reaggregation. Segment related phrases appeared more than 20,000 times in the selected reports. This frequency was larger than any other grouping of related words and phrases except for income statement related phrases. Analysts use a variety of phrases to refer to the operating units of corporations, including "lines", "areas", "businesses", "divisions", "units", "segments", and "subsidiaries". [Also included in 1(b) and 3(e)] **[PREVITS, p. 15]**

[Equity sell-side] analysts employ a literal definition of nonrecurring income statement items, which are usually referred to as "one time" items. They take notice of reported nonrecurring items as listed below continuing operations and also note the effect of new accounting rules. One report contained a section entitled "Non-operating earnings - A Source of Confusion in the Past". [Also included in 1(b), 5(a), and 5(d)] **[PREVITS, p. 15]**

[Equity sell-side analysts] also identify "potential" nonrecurring items contained in continuing operations, and often report EPS net of these items, as in the case of the analyst who noted "several unusual items" included in continuing operations. Correspondingly, a number of analysts report operating earnings per share, which of course is not required under GAAP, or compute an "adjusted earnings" number which includes all items judged to be nonrecurring, and corresponding EPS. Restructuring charges are an example of one common item often removed in analysts EPS reports. Occasionally analysts identify a nonrecurring cost but are unable to estimate an amount. In one case an analyst was unable to determine the amount of a corporate relocation charge buried in continuing operations. In another report the relocation charge of the company was identified in continuing operations and removed in calculating EPS. [Also included in 1(b), 5(a) and 5(d)] **[PREVITS, p. 15-16]**

[Equity sell-side] analysts discuss a company's "earnings power" or "earnings momentum". One report, for example, commented on a firm's "strong accelerating growth". This appears

to be something different than the earnings growth rate reported, which is linear, and suggests a nonlinear growth component. [Also included in 1(b)] **[PREVITS, p. 16]**

The "stability" of a company's earnings is addressed by [equity sell-side] analysts who frequently assess the degree of uncertainty of future earnings, often in terms of "risk". Analysts do not, however, provide explicit evidence that they identify discretionary accruals of management to smooth income. One the other hand, as noted in the discussion of "earnings quality", analysts are attentive to some accruals. [Also included in 1(b) and 10(d)] **[PREVITS, p. 16]**

[Equity sell-side] analysts define "earnings quality" differently than [was] expected. To financial analysts, a company with high earnings quality is one that uses very conservative accounting principles; for instance a company that has accrued reserves against future losses, write downs, etc. One analyst, for instance, reported earnings quality as high when a firm had an "aggressive" policy towards establishing reserves. Another substantiated an assertion of high earnings quality for a company by stating that "the company is over-accruing foreign taxes as a way of managing earnings." A third supported its assertion of high quality earnings by noting that "the opportunity to 'manage down' earnings exists". A fourth argued that a financial company's earnings were more 'credible' because the company applied "more aggressive accounting" methods in writing down assets. [Also included in 1(b) and 5(a)] **[PREVITS, p. 16]**

This suggests a possible analyst preference for secret reserves. [Also included in 1(b) and 5(a)] **[PREVITS, p. 16]**

[Sometimes,] earnings quality . . . seem[s] to be related to "representational faithfulness," and management's forthrightness in disclosure. For example, one analyst reported that an extreme drop in the reported tax rate of a company "caused some to doubt the quality of (its) earnings". Another expressed concern about earnings quality on the basis of the amount of costs included by a company in the determination of cost of goods sold. [Also included in 1(b), 2(b) and 5(a)] **[PREVITS, p. 16]**

Other income analysis factors:
- Analysts see a "strategic acquisition" to be one which reduces a company's short term earnings but increases longer term earning potential.
- Analysts report sale backlog (at company or operating unit levels) and use these as a basis for estimating future performance.
- Average tax rates are calculated for most companies with income data on a comparative and trend basis. Current and deferred portions of income tax expense are often disclosed.
- Regulated companies reported "statutory" or regulatory income compared with GAAP income. [Also included in 1(b) and 5(a)] **[PREVITS, p. 16]**

The balance sheet receives far less attention than the income statement [by equity sell-side analysts], and the occurrences of balance sheet type words and phrases occur far less frequently [in analysts' reports]. Much of the attention to balance sheet items comes in the form of liquidity and cash flow analysis. For example, reports may assert balance sheet strength on the basis of a company's free cash flow. While several income statements are

almost always presented, many reports contain only summary balance sheets [Also included in 1(b), 5(b), and 5(c)] **[PREVITS, p. 17]**

Long term productive asset values on the balance sheet are nearly always evaluated at cost [by equity sell-side analysts]. The effect of inflation on such assets rarely is explicitly considered. However, for some companies, a supplemental analysis of assets' market value is conducted. This is undertaken for firms analysts consider to be poorly understood by other analysts and investors, and particularly where latent significant off-balance-sheet or hidden assets may exist. [Also included in 1(b), 4, and 5(b)] **[PREVITS, p. 17]**

[A]nalysts asserted that a cable television company had substantial off-balance-sheet assets in the form of residual payments to be received in the future. They calculated the value of the company using several methods, one being the present value of the anticipated cash flows from these residuals. One analyst stated that "balance sheet recognition of . . . hidden asset values . . . will occur in future years". Other examples include inventory and reserve valuations of extractive industry companies. For instance, in gold mining companies, a market value appraisal is included of the reserve values by ore type. [Also included in 1(b), 4, 5(b), and 5(c)] **[PREVITS, p. 17]**

[Equity sell-side] analysts periodically examine the quality of assets, particularly in troubled industries such as banking and insurance. Here, attention is paid to nonearning assets, non-performing assets, and the quality of assets (loan portfolios) and investments. [Also included in 1(b) and 5(b)] **[PREVITS, p. 17]**

Liabilities are usually addressed in a summary fashion, often in a simple analysis of the capitalization of the corporation. Extensive attention to liabilities usually only occurs for companies that are highly leveraged and typically in conjunction with a cash flows analysis. [Also included in 1(b), 5(b), and 5(c)] **[PREVITS, p. 17]**

Cash flow analysis [by equity sell-side analysts] displays considerable variety in format and content. Many reports present and/or discuss cash flow extensively. Cash flow information is sometimes presented by segment or operating unit. Some reports make no mention of cash flow at all. Cash flow type phrases occurred about 6,000 times in the full sample. [Separately, dividends are mentioned over 2,000 times.] [Also included in 1(b), 3(c), and 5(c)] **[PREVITS, p. 18]**

Although cash flow per share calculations are not permitted in audited filings under SEC rules nor by SFAS 95, cash flow per share and operating cash flow per share are almost always calculated by analysts when they provide any cash flow data. Analysts also calculate "fully diluted cash flow per share" and some provide "distributable cash flow per share", "excess cash flow per share", "discretionary cash flow per share", and "free cash flow per share." [Also included in 1(b) and 5(c)] **[PREVITS, p. 18]**

Some [equity sell-side] analysts compute a price to cash flow ratio, and present a comparison of this ratio with other companies in that industry. Others assess the relationship between cash flows and earnings. For example one report stated that the value of a company was "compelling" because "operating cash flows are 4.3 times 1990 earnings". Another analysts

encouraged purchase of a major tobacco company's stock because of its "tremendous surplus cash flows". [Also included in 1(b) and 5(c)] **[PREVITS, p. 18]**

Cash flows seem to be more important to [equity sell-side] analysts in evaluating smaller companies, and less so in evaluating larger companies, with the exception of highly leveraged larger companies or ones in which a dividend cut is possible. One report, for example, states that "The important figure . . . for evaluation of smaller petroleum . . . companies is operating cash flow per share." Another stated that in comparison with cash flow "historical financial results of [the company] are irrelevant". [Also included in 1(b) and 5(c)] **[PREVITS, p. 18]**

Examples of unorthodox cash flow formats [presented by equity sell-side] analysts in addition to free cash flow and discretionary cash flow arrangements are:

Net income
+/- all effects except cash interest
= cash flow available to common
- cash interest
= net cash flow

Direct operating cash flows
- priority outflows
- discretionary outflows
+ financial inflows
= change in cash

[Also included in 1(b) and 5(c)] **[PREVITS, p. 18]**

It was also intriguing to discover an example where the "foreign exchange cash flow" in a statement of cash flows was presented outside the three traditional categories of the SFAS 95 format. [Also included in 1(b) and 5(c)] **[PREVITS, p. 18]**

[Equity sell-side] analysts distinguish between valuations based upon the company's continued existence in its present form: so-called fundamental value, and valuations based upon acquisition or breakup of the company. Analysts use several approaches to valuing companies based on fundamentals, most typically in terms of the present value of the company's cash flows, its earnings, or balance sheet valuations. In this approach analysts also distinguish between a company's "Public market value" and "private market value". For example, one analysts measures the fundamental value of a company in terms of:

1) Private market value
2) Price/revenues
3) Price/book value
4) Price/long-term earnings
5) Growth-driven valuation composite
6) Contrarian composite [e.g. Bearish Sentiment Indicators]
7) Earnings momentum composite
8) Technical ranking
9) Beta

[Also included in 1(a), 1(b), and 4] **[PREVITS, p. 19]**

Another analyst valued companies in terms of revenue, cash flow multiples, and net income. And yet another analyst valued a cable TV company with purported off-balance-sheet assets on three basis:

1) present value of cash flows,
2) appraised value of assets and
3) the company's liquidation value.

[Also included in 1(a), 1(b), and 4] **[PREVITS, p. 19]**

Another analyst evaluated the same cable TV company by analyzing each of the many limited partnerships with which the company was related in order to estimate the long-range cash flows of each to the company. [Also included in 1(a), 1(b), and 4] **[PREVITS, p. 19]**

Analysts label valuations of a company based upon it acquisition or breakup as it "buyout value", "breakup value", "takeover value", "theoretical breakup value", and so forth. Examples of computed break up value include the following:

1) Estimated breakup value = asset values at market price less liabilities.
2) Adjusted breakup value takes the above and adds other "likely" assets.
3) Possible breakup value adds other "possible" assets to all of the above.

[Also included in 1(a), 1(b), and 4] **[PREVITS, p. 19]**

[Context] The AIMR position paper provides the following summary of the section (pages 6-11) entitled "Financial Analysis and Financial Reporting":

This section provides primarily descriptive information. It discusses the interrelationship between the efficient market hypothesis (EMH) and other theories of financial economics and the role of financial analysis in making markets efficient. It presents a description of the analytic process to the extent that generalizations can be made in that area. It lists and describes the vast variety of information sources used by analysts, of which financial reports are an indispensable part of the whole. It then describes in more detail each of the financial reports analysts rely on in their work. [Also included in 1(a) and 1(b)] **[AIMR/FAPC92, p. vi]**

One of the most important points made in this section is defining the distinction between financial analysis and financial reporting. We believe that financial reporting should be concerned with presenting the economic history of specific economic entities and that it is best done when managements also are willing to disclose and discuss their strategies, proposed tactics and plans, and their expected outcomes. Forecasts of the future and similar material enhances financial report usefulness, but must be separated from and not confused with the financial statements themselves. The function of analysis is to allow those who participate in the financial markets to form their own rational expectations about future economic events, in particular the amounts, timing and uncertainty of an enterprise's future cash flows. Through this process, analysts form opinions about the absolute and relative value of individual companies, make investment decisions or cause them to be made, and thereby contribute to the

economically efficient allocation of capital and clearing of the capital markets. [Also included in 1(a) and 1(b)] **[AIMR/FAPC92, p. vi]**

[Context] Those two paragraphs introduce the following excerpts and relate them to excerpts from the same section included in 1(a)-Investors' and creditors' objectives and approaches and 1(b)-Types of information that investors and creditors use . . . .

Distinguishing Financial Analysis from Financial Reporting
It is quite easy to make a conceptual distinction between financial reporting and financial analysis. Although both result in expressions of worth or value, their perspectives are diametrically opposed. Financial statements express net worth as the surplus of total assets over total liabilities. Assets and liabilities are both the result of *past* transactions and events, thus so is the accounting measure of net worth. Financial analysis, on the other hand, assesses, estimates and gauges value solely in terms of expectations of the *future*. A standard concept of value is that embodied in the dividend discount model (DDM), described above as postulating the value of a security to be the present value of its expected future dividends plus its estimated residual price at some specified future date, discounted at a risk-adjusted rate of return (opportunity cost of capital). Thus financial analysts seek to prognosticate the amounts, timing and risk attached to a firm's future cash flows, either directly or through surrogates, such as earnings forecasts. [Footnote reference omitted.] **[AIMR/FAPC92, p. 8]**

Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," states in paragraph 37:

> Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption or maturity of securities or loans. The prospects for those cash receipts are affected by the enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations, and to pay cash dividends and may also be affected by perceptions of investors and creditors generally about that ability, which affect market prices of the enterprise's securities. Thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective cash flows to the related enterprise. **[AIMR/FAPC92, p. 8]**

A footnote to paragraph 37 explains that the objective "neither requires nor prohibits `cash flow information,' `current value information,' `management forecast information,' or any other specific information." *Statement of Financial Accounting Concepts No. 5*, "Recognition and Measurement in Financial Statements of Business Enterprises," on page 5, limits measurement in accounting to the financial statements themselves. **[AIMR/FAPC92, p. 9]**

The question then arises as to the proper relationship between: (a) financial statements; (b) notes to financial statements, supplementary information, and other means of financial reporting; and (c) financial analysis, which according to *Statement of Financial Accounting*

Concepts No. 5 falls outside of financial reporting. To what extent should assessment of the amounts, timing, and uncertainty of an enterprise's future cash flows fall into each of those three categories? **[AIMR/FAPC92, p. 9]**

We believe that financial reporting should be concerned with presenting the economic history of specific economic entities and that it is best done when managements also are willing to disclose and discuss their strategies, proposed tactics and plans, and their expected outcomes. It is self-evident that reporting on the past always requires the use of estimates and other assessments of future events: uncollectible receivables, depreciable lives, warranty repair costs, and the like. Forecasts of the future and similar material enhances financial report usefulness, but must be separated from and not confused with the financial statements themselves. Financial analysts avidly seek management's forecasts as part of the financial reporting process, accompanying but not incorporated in the financial statements. **[AIMR/FAPC92, p. 9]**

Financial analysts, in turn, have the task of digesting all relevant economic information that can affect an economic entity, including but not limited to its financial reports. The function of analysis is to allow those who participate in the financial markets to form their own rational expectations about future economic events, in particular the amounts, timing and uncertainty of an enterprise's future cash flows. Through this process, analysts form opinions about the absolute and relative value of individual companies, make investment decisions or cause them to be made, and thereby contribute to the economically efficient allocation of capital and clearing of the capital markets. Allocation decisions are made primarily on the basis of comparisons. **[AIMR/FAPC92, p. 9]**

Financial reporting and financial analysis cross paths because, ultimately, economic value (wealth) is created by expectations of future inflows of economic benefits, primarily in the form of or the equivalent of cash flows. The amounts and timing of future cash flows are in most cases uncertain to various degrees. It is the function of analysis to deal rationally with that uncertainty. It is the function of financial reporting to provide data useful to analysts making assessments of an enterprise's future cash flows and its value today. Such data include detailed and up-to-date information on the amounts and timing of past cash flows, periodic wealth increases from operating activities (profitability), economic status at regular past intervals, together with an abundance of supplementary data necessary to understand their content and significance. **[AIMR/FAPC92, p. 9]**

Some persons may confuse the roles of financial reporting and financial analysis because of the function of forward-looking information, which is essentially of two different types. First are amounts that we expect to see reported in financial statements and subject to audit: receivables, payables, a variety of financial instruments reported at the present value of their future cash flows. These are contractually-determined amounts arising from past exchanges that meet the definitions of assets or liabilities, even though their value may properly be determined by the amounts of related future exchanges. The other type of forward-looking information comprises forecasts, projections, and certain pro-forma presentations. These numbers are of great importance and usefulness to analysts, but they are not part of the economic history of the firm and therefore not proper financial statement components. Nor are they auditable, although the participation of an independent accountant in their preparation could well enhance

their credibility and "user-friendliness" as well as provide some assurance that management's methodology was sound, its assumptions reasonable, and its calculations accurate. **[AIMR/FAPC92, p. 9-10]**

How Financial Reporting Can Serve Financial Analysis

The starting point in analysis of a specific company is to look at the record. How has that management and company performed in the past and what is its status at present? Answers to those questions are found in the company's financial statements. Past performance is evaluated in terms of profitability and liquidity, current status in terms of financial position. Financial statements are valuable to the extent that they provide useful and comprehensive information that allow financial analysts to evaluate how well management has done with the resources at its command. Although the word "stewardship" no longer is fashionable, it fits here. In fact, it continues to be a major reason for the accounting profession to continue producing financial statements in their traditional format. **[AIMR/FAPC92, p. 10]**

The specific content of financial statements is discussed in more detail in other sections of this report, but it is important here to state how essential it is that the financial reports should be comprehensive. If we are to have financial statements in the traditional form, they ought to include what they purport to contain. For example, many so-called "off-balance sheet" items should be on the balance sheet. Another matter on which all analysts are agreed is the urgent need for the FASB to develop, in the form of financial accounting standards, the notion of "Comprehensive Income" that it introduced in Concepts Statements Nos. 3 and 6. If done properly, such standards would bring back to a structured income statement various items that now bypass income on their way to the owners' equity section of the balance sheet. The topic of comprehensive income is discussed at greater length later in this report. **[AIMR/FAPC92, p. 10]**

Analysts need financial statements structured so as to be consistent with how the business is organized and managed. That means that two different companies in the same industry may have to report segment data differently because they are structured differently themselves. Perhaps one may be organized by product line, the other by geographical area, or by the types of industries represented by its customers. There are even more possibilities of organizational differences between and among companies in different industries. Some may be production oriented, others driven by markets or research activity. We also are aware of the difficulty of setting accounting and disclosure standards to meet our needs and our more detailed topical discussions later in this report incorporate that concern. **[AIMR/FAPC92, p. 10]**

Financial reports have to be understandable. Analysts are quite aware of the technically demanding nature of certain accounting standards and we sympathize with financial statement preparers and their auditors for the additional work they must do. However, these standards were promulgated because they are intended to provide vital economic information to investors, creditors and other financial statement users. We worry that the purpose of a standard can be thwarted by a grudging compliance with only its technical requirements. We look in financial reports for information -- and often its provision requires explanations that go beyond the bare minimum reporting requirements contained in a standard or checklist. **[AIMR/FAPC92, p. 11]**

The financial reporting process is most useful when it goes beyond the past and present to include management's views of its future strategies, plans and expectations. For example, currently management is required in the Management Discussion and Analysis (MD&A) section of its annual report to shareholders to report how the results of each of the past three years differ, one from another. The SEC strongly encourages, but does not require similar discussion of how management expects the results of future years to differ from those of the past. Why have managements been so slow to respond to this urging? We have seen some improvement recently, but the pace is glacial. **[AIMR/FAPC92, p. 11]**

Financial reports also should provide assurance that the organization is under control. At one extreme, that means that it conducts its affairs at least lawfully and (we hope) ethically in all the jurisdictions and cultures in which it operates. In another sense, we seek assurance that the company is being operated in the interests of its shareholders and creditors for the purpose(s) asserted to them and with the goal of maximizing their wealth in a responsible manner. We expect business firms not to contribute to social injustice or environmental degradation, although individual analysts have different concepts of how these politically sensitive goals can best be achieved. What all analysts need is a depiction of what the enterprise is doing in these areas as well as assurance that control systems to ensure continued compliance are in place and operative. We also believe this is an area for expanded activity by internal and independent accountants. **[AIMR/FAPC92, p. 11]**

Finally, we note that mark-to-market accounting is intended to apply to individual assets and/or liabilities, either singly or in portfolios of homogeneous components. Despite our overall opposition to its imminent adoption, we consider it to be appropriately within the domain of the accounting function. On the other hand, when it comes to the valuation of business enterprises, either singly, in groups, or by components, we rightfully regard that as the province of financial analysis and a matter beyond the scope of financial reporting. [Also included in 4] **[AIMR/FAPC92, p. 29]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing their basic objectives and approaches to evaluating equity securities, some investors referred to the way(s) they use the information provided in external reports to achieve their objectives.

Participant I-4
I think historical numbers are necessary but not sufficient to do fundamental work. The people here from the investment field are probably all fundamentalists. We do special situation work, we are trying to determine what is the real corporate value of companies which we are analyzing or buying. We attempt to analyse cash flows and/or redundant assets, and then putting some kind of capitalization rate on that growth. So it is important for us to look at what we think is real generation of cash flows; for that, you need historical data but also a lot of judgment work. Once we determine what value is, we attempt to find whether the company agrees with us in realizing value. A lot of the value comes out because corporate activity occurs, not because the stock market goes up or down, but because someone internally realizes

that values in a real world are substantially higher over time than what the price is in the marketplace. [Also included in 1(a) and 1(b)] **[TI 10/16, p. 5]**

Participant I-9
We have about $20 billion under management and a research department of about 7 or 8 people. It used to be that an institution of that size would have about 30 analysts; those days are over. Which means that the job of the financial reporting community has become more important; the analysts cannot know the industries in the same depth they did before. We never make an investment unless we have audited financial statements of the company and we don't make an investment unless we meet the management of the company. Our approach is fundamental; the valuation starts with the financial statements and then our projections going forward, based on what management tells me and what we see in the trends of the company. The other aspects are psychology and momentum; the accounting profession cannot help us with that. Sometimes, we rely heavily on the information provided in financial statements, at other times that's not what is going to lead us to make the right investment decision. [Also included in 1(a) and 1(b)] **[TI 10/16, p. 5-6]**

Participant I-10
We all know we are severely limited on how far we can look into the future. When you visit companies and go through their own plans and their own views of themselves, you normally get 3, 4, 5 year plans; to some extent, we are tied to that time period. Studies have shown that if you can project earnings for a period of five years, you are way ahead of most stock pickers and you will do very well with no other information. So, something like 3 to 5 years is probably reasonable for what we are trying to do. Sometimes, you are more secure in your 5 or 3 year projection than you are in your 1 year projection. We are in the business of making judgments about where earnings are likely to be in the next number of years, and the quality of those earnings. It is a very complicated process and I would guess that we are not making projections for 10 or 20 years. [Also included in 1(a)] **[TI 10/16, p. 7-8]**

Participant I-7
As far of our organization is concerned, we are required to have an estimate for the current quarter, the current year, the following year, and a percentage number for the subsequent five years. [Also included in 1(a)] **[TI 10/16, p. 8]**

Participant I-11
In our firm, we make detail models 4 to 8 quarters out and we have a 3 to 5 year trendline growth expectation related to expected ROE. Beyond 3 to 5 years, there are so many exogenous factors that affect the economy and business that you're kidding yourself if you think you know what is going to happen further out. [Also included in 1(a)] **[TI 10/16, p. 13]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. After discussing their basic objectives and approaches to evaluating equity securities and the types of information they use to

achieve their objectives, investors were asked the following questions on the ways they use the information:

- Do you standardize your process for analyzing the mass of information?
- Do you have a sequential process; do you have a routine; what do you go through?
- Does every analyst and manager have the freedom to analyse the information in any way they want?

Participant I-7
On all the companies that I cover, I have a model. The complexity of the model depends on the size and the diversity of the company. The model may be no more than an annual historical P&L representation, an historical quarterly, and also a forecast of the current year and the subsequent year. **[TI 10/16, p. 49]**

To the extent that the companies I follow provide us with some FAS 14 disclosures, I will incorporate in my model an attempt to tie the segmented earnings numbers to my annual and quartely model for the whole company. Increasingly, I have started for larger companies to make an attempt to project some kind of growth rate by business segments for the next 3 to 5 years. [Also included in 3(e)] **[TI 10/16, p. 49-50]**

Participant I-12
I don't bother building models for any company that is in a high risk area. A lot of people in the business right now would say don't touch [name deleted] because a third of their loans is in real estate in California. So why make the effort of building a model for a company like that? I do a screening process that is more intuitive than anything else and when I get to building a model, I do a P&L model, selective balance sheet items, and I typically will project out for 3 to 5 years on a worse and best case scenario. **[TI 10/16, p. 50]**

Participant I-6
I start with all the details and do a "bottoms up" and that is easier with a basic industry company than a financial company. Even though there is a lack of data, the FAS 14 disclosures of some companies is fairly decent annually. I will look at the production by mine, by plant if I can get it, then I will build up the unit side of the equation and then multiply that by our expectation of the unit selling price to get a revenue-driven model. When we can, we break down the various cost components and forecast those. The production data feeds the income statement, feeds the cash flow statement, feeds the balance sheet, which feeds about 15 standard ratios that we use. You look for variations in those ratios each quarter or each year. That's the methodical part that takes very little of your time. That's where you start. [Also included in 3(e)] **[TI 10/16, p. 50]**

Participant I-8
I think we are all the same. It depends on the nature of the company you follow. You're looking for the gross margin and what the pattern has been, R&D as a % of sales, and whatever detail you can get. So you have 2 things that it gives you: what has been the

historical pattern within the company and how the company and its ratios compare to other companies. **[TI 10/16, p. 50]**

Participant I-9
We start with the annual report and that suggests questions. Then I go see as high a person in the company as I can and try to get the sales and objectives of the chairman of the company and see if that makes sense in relation to the profitability of the business and the trends in the industry and identify the key areas that are crucial. Then you monitor that very closely and get conviction. If there is a new development, you call an analyst on the street or call the company, and read the financial statements of the company, to see if you should adjust your projections. **[TI 10/16, p. 51]**

Participant I-1
We try to overlay a lot of qualitative factors, particularly in terms of change; we are real change junkies. If something is going to stay the same, we can't bring much value-added in, the market is efficient, so we are wasting our time. We try to identify change catalysts in one form or another, then we will build our model based upon that. Then, we run a fair amount of sensitivity off of it; we're downside oriented or concerned. So we're looking at the worse case scenario. **[TI 10/16, p. 51]**

Committee/Staff/Observer
What kinds of statistical information do you routinely prepare from the financial and nonfinancial information that you have identified? Do you routinely prepare ratios and % and what are they? Give us some specific examples. Do you have a standardized list of ratios and %? Implicit in that is that if you do, perhaps they should be included in our product automatically? **[TI 10/16, p. 51]**

Participant I-6
A couple of simple ones: book value, debt ratios. Trying to do the book value is difficult on a company based on their quarterly numbers. First of all, most companies don't report actual shares outstanding, they give the average for the quarter; that doesn't help you get a book value number. Debt ratios: every company that I follow has its own little twist to it. I think the value that the accounting profession could bring is some standardized ratios that would be reported and audited on an annual or quarterly basis and have very specific definitions for those ratios. [Also included in 11(c), 13, and 17(b)] **[TI 10/16, p. 51-52]**

Participant I-3
Because the companies that I follow even in the same industry don't report their financial information in a comparable manner, I look at a lot of productivity and cost relationships. Obviously, I can't get them from the reported information. It also helps me understand the dynamic changes within an industry and the relative abilities of companies to operate in very competitive industries. **[TI 10/16, p. 52]**

Participant I-8
The accounting concept of materiality is of concern to me. What is perhaps by definition not material, I've heard 5% or 10% or whatever is being reported, can be a 150% of some

increment that we're looking at (earnings, gains, or whatever) and somebody had to reconcile the accounting and financial analysis notions of materiality. **[TI 10/16, p. 52]**

Participant I-7
I have about 20-25 pages of historical ratios on the companies that I follow within my industry. I put them on a least squares basis (annual) to offset the starting and ending point. **[TI 10/16, p. 52]**

Participant I-11
The only trouble is that you can't do a log linear regression when you have loss periods. I do agree though that for most industries, there is enough static from year to year that if you just look at a start point and an end point, you can come up with a really misleading number. The things that are important to you as an analyst depend heavily on what kind of industry you're analyzing. Maybe it boils down to say that in every industry there are certain key ratios and certain key data that management use to run and measure their business. To the extent possible, we would like to have access to those measurements. Taking the wholesale distribution as an example, a couple of key measures are average order size and average line items per invoice. It would be useful to me to make predictions to have access to those figures. **[TI 10/16, p. 52-53]**

Participant I-7
I'm interested in knowing the ratios, the information that you look at from an internal point of view providing it is not going to hurt your business position. I want that information. [Also included in 13] **[TI 10/16, p. 53]**

Participant I-1
Any company which depends upon bids for its business will generally issue a backlog list; the only thing you can track as an externalist is what they publish as a rolling backlog and you have no concept of what kind of margins they bid those contracts at until 18 to 36 months later when it flows to the income statement. [Also included in 13] **[TI 10/16, p. 53]**

Participant I-7
I had that exact situation where a company in the capital goods industry had an earnings problem and we missed it because, in the prior 6 months, they had taken business in the backlog with a narrow margin. I know that at the plant level that information is available and that should not have happened. [Also included in 13] **[TI 10/16, p. 53]**

Participant I-1
On the one hand, as investors, we want to know immediately how they bid on that contract. On the other hand, they will argue vehemently that it is a highly competitive industry and they can never give away what the margins were for contracts because they may have a strategic reason on a given contract. I don't know how you balance that out in a particular industry. [Also included in 13] **[TI 10/16, p. 53]**

Committee/Staff/Observer

This relates to projected information. Do you prepare cash flows, earnings statement, balance sheet on a projected basis? If so, in what degree of detail? For how many future periods? **[TI 10/16, p. 54]**

Participant I-6
I go into as much detail as I possibly can get and that usually is quarterly by segment: income statement, cash flow, I don't do that much on the balance sheet, definitely the equity section and maybe the debt section. Quarterly for the current year and the next year, and then annually for at least 5 years. [Also included in 3(e) and 11(e)] **[TI 10/16, p. 54]**

Participant I-1
We used an integrated sort of hybrid LBO model which has income statement, balance sheet, and cash flow statement. We run it out the full 10 years and cut the last 5 as being worthless. We try not to get into quarterlies because it distracts us from our long-term orientation. [Also included in 11(e)] **[TI 10/16, p. 54]**

Participant I-11
We also do quarterlies for the current and next fiscal year, so somewhere between 5 and 8 quarters of estimates at any one time. On the P&L, typically in the format that the company presents the data. We will do detailed cash flow analyses over that period if it looks like there is a cash flow issue to be addressed, but not as a matter of course. [Also included in 11(e)] **[TI 10/16, p. 55]**

Participant I-5
It varies. There is one company that I never projected a single number for that we recommended. And there have been companies where you have to go out 5, 7 or 8 years. **[TI 10/16, p. 55]**

Committee/Staff/Observer
Let's talk about the company you recommended with no projection for. How and why? **[TI 10/16, p.55]**

Participant I-5
It was a debt instrument with a balance sheet-driven story and a company whose results were flatish on a cash flow basis. The balance sheet, on the other hand, had $60 million of cash, $40 million of debt, and the debt was trading at $.25 on the dollar, yielding 25%. **[TI 10/16, p. 55]**

Participant I-6
In the mining industry, you have to project your operating data. As I said two hours ago, we lack good operating statistics in the U.S. We get much better operating statistics overseas. I start with the basic output of each mine to get down to how much they are going to earn in that quarter. [Also included in 13] **[TI 10/16, p. 55]**

Participant I-12
You should try getting operating data for financial companies. How many loan customers do you have? What is the average balance? What I have done is find out all kinds of data sources and created a rather weird model for interpolating those kinds of things and making estimates going forward about potential growth rate for given geographic areas. But it's a lot of work but if we're in a world of low inflation, that unit growth of number of customers is going to be critical in this particular industry. That's one area where financial companies under-report comparative to industrial companies. [Also included in 13] **[TI 10/16, p. 56]**

Committee/Staff/Observer
We talked about projected financial information that you all make and I think it is almost a consensus that you're projecting primarily income statement-type information for 2 years to maybe as many as 5. Can you help us understand how you then take those projections and convert them into a stock price? **[TI 10/16, p. 57]**

Participant I-2
I look at a relative multiple compared to the S&P 500. If you go back to a very high interest rate period, maybe the relative multiple to the S&P is none and just before the 1987 crash, it was maybe 18. **[TI 10/16, p. 58]**

Committee/Staff/Observer
Would you adjust the multiple if you thought that the company has great prospects beyond year 5? **[TI 10/16, p. 59]**

Participant I-2
Yes, it's a dynamic situation. Some companies have a small denominator and grow rapidly but when the denominator gets bigger, they grow very slowly. So you would be inclined to be edging your relative multiple down. Other companies have a new product cycle or there is a rapid growth in a new business, then you tend to increase the multiple. It's much more important to look at relative multiples than at absolute multiples. **[TI 10/16, p. 59]**

Committee/Staff/Member
Most of you are using multiple of earnings rather than discount of future earnings? **[TI 10/16, p. 59]**

Participant I-9
It takes 3 to 5 years to train a security analyst. How much you pay them depends on how they use the information and it's not rational. Engineers and accountants usually want to have a system where 2 follows 1 by the same distance that 3 follows 2 and that's not the business we're in. **[TI 10/16, p. 59]**

Participant I-12
I use price to adjusted book value in addition to relative P/E. Book value can be adjusted for a number of things. First, you have to add in the future cash flows that you have estimated and then you look at market price and all the black box process that we analysts do. But I adjust book value for earnings factors and for cyclical factors to arrive at a ratio that I can then apply to my adjusted book. **[TI 10/16, p. 59]**

[Context] Responses to the postmeeting questionnaire to the October 16, 1992 Investor Discussion Group meeting.

QUESTION 2

We understand that investors who use the fundamental approach to equity security analysis generally determine the intrinsic value of an equity security and the underlying company by:

(a) Applying a multiple to their predictions of the company's *normalized* or *core* future earnings

(b) Discounting at a risk adjusted rate of return their predictions of the company's future cash flows, future dividends, or future earnings

- Do you know of an other way that is used to determine intrinsic value?

Yes (see descriptions below)	*6No 3*

Descriptions of other ways to determine intrinsic value:

→*Participant I-4:* Applying appropriate cap-rates to projected cash flows gives a more complete picture of business value; assume one is buying the entire company not just equity securities

→*Participant I-9:* (1) Break up value, (2) Merger value--i.e., synergistic benefits such as cost savings, selling more products through a combined sales force, (3) current yield relative to short-term money rates & U.S. treasury note yields.

→*Participant I-17:* For companies with diverse operations, there could be "hidden" value in one division that is obscured by the operations of the overall company. In this case, evaluation of each individual operation (i.e., the parts are worth more than the whole) would be most relevant.

→*Participant I-8:* A company, for example, can have two parts. One nicely profitable and an offsetting unprofitable business. In such a case, the intrinsic value would be a valuation of the good business as described above plus an estimate of the value of the poor business to a competitor.

→*Participant I-11:* In some cases, estimating the current or future "real" value of the company's assets (i.e., the economic value of raw material reserves for a natural resource company).

→*Participant I-12:* Assessing realizable book value per share and applying some premium or discount to reflect current and/or expected growth in that book value - works better for financial rather than industrial companies.

a. Regarding investors who apply a multiple to their predictions of the company's *normalized* or *core* future earnings:

- We understand that most professionals in the investment community apply a multiple to their predictions of the company's future earnings.

  Does that agree with your experience?

Yes	*9*
No	*0*

- How far into the future do those investors predict earnings?

Quarters for the current year	*7*
Quarters for the following year:	*4*
Annual earnings for the following year	*8*
Annual earnings for years 3 to 5	*9*
Growth rate of earnings for years 3 to 5	*7*
Annual earnings beyond 5 years	*0*

- How do those investors determine the multiple?

A historical P/E ratio for the company	*5*
The historical relationship between the company's P/E ratio and the P/E ratio for the market, sector, or industry	*5*
The current P/E ratio for similar companies	*6*
An estimated P/E ratio based on factors such as common stock prices, earnings, growth, risk, time value of money, and dividend policy that are weighted on the basis of their or their colleagues' professional judgment	*2*
An estimated P/E ratio based on factors such as common stock prices, earnings, growth, risk, time value of money, and dividend policy that are weighted by the use of regression analysis or other statistical process?	*2*

Other	*Description*
Participant I-4	Probably all of the above with varying success--I think the answer (correct) is closest to the [estimated P/E ratio based on factors such as common stock prices, earnings, growth, risk, time value of money, and dividend policy that are weighted on the basis of their or their colleagues' professional judgment] although the answer creates an entirely new book of questions regarding one's interpretation of risk, etc.
Participant I-17	And, at any point in time, a judgment of whether those earnings are in fact "normal," "peak," or "trough."
Participant I-8	My way. Base a multiple expectation on company's return on equity and return on assets relative to the market and as a whole and its projected multiple out three years and also have an opinion on the company's reinvestment opportunities beyond three years.
Participant I-9	I look at the current P/E and then try to decide whether it will move up or down based upon both current fashions in the stock market and by trying to determine what future fashions will be.
Participant I-10	One generally needs to make a judgment about the market's P/E in order to go from relatives to absolutes.
Participant I-11	I have seen each of these approaches used, depending on the investor and on the facts and circumstances of the case.
Participant I-12	Estimated P/E ration based on general economic conditions combined with company/industry market factors listed above.

b. Regarding investors who discount their predictions of the company's future cash flows, future dividends, or future earnings:

- Do you discount at a risk adjusted rate of return your predictions of future cash flows, future dividends, or future earnings?

Yes	*3*
No	*6*

Participant I-9: I do not use a discounted rate of return method. For periods beyond 3 years it is too hard to predict both earnings growth with conviction and the discount rate which depends upon both psychology and the level of interest rate. I have found this method consistently over values stocks with high current year growth rates. It is usually an inertia forecast using current growth and current interest levels.

- If not, do you know of someone who does?

Yes	*2*
No	*3*

- If you answered "Yes" on either of the two preceding questions, please continue with the following questions:

  - Do investors who discount at a risk adjusted rate of return most commonly discount:

Cash flows?	*3*
Dividends?	*0*
Future earnings?	*3*

  - Do investors who discount cash flows usually derive cash flows from earnings by adding net noncash expenses?

Yes	*5*
No	*0*

  - How far into the future do they predict cash flows, dividends, or earnings?

Six to twelve months	*0*
Twelve to eighteen months	*1*
Eighteen months to two years	*2*
Two to four years	*5*
Five years	*2*
Beyond five years	*0*

- Please describe how they determine the discount rate.

→*Participant I-4:* Art form--developed through an individual's analysis of relative risk of future cash flows vs. relative certainties now known.

→*Participant I-17:* 1) Take the expected rate of return for the market
2) Subtract the 1 year T-Bill rate from that expected rate
3) Multiply that figure by the stock's beta
4) Add that figure to the T-Bill rate

Example:		
	Expected Market Return	12%
-	T-Bill Rate (riskless rate of return)	4%
	Equity Risk Premium	8%
X	Individual Stock Beta (1.25)	10%
+	T-Bill Rate	4%
=	Discount Rate	14%

→*Participant I-10:* I believe the discount rate requires: a) risk free rate, b) growth of co., and c) a desired return above the risk free rate. Method is very sensitive to small changes.
→*Participant I-11:* Generally, they add some risk factor to the current (or expected) "risk free" rate--i.e., T-bills.
→*Participant I-12* Most analysts use Treasury bond rates and add back some personally derived risk factor. Others impute a "cost of capital" based on core earnings divided by the stock price. Practice varies widely- any basic finance textbook could probably provide some basics.

[PMQI 10/16, p. 2-7]

QUESTION 7

What kinds of statistical information do you routinely prepare from the nonfinancial and financial information available? For example, do you routinely compute:

- Ratios and percentages that help you assess relative profitability, productivity, and risk?

  Yes 9

  No 0

- Statistics that measure changes over time, such as annual growth rates?

  Yes (see descriptions below) 9

  No 0

  Descriptions of statistics that measure changes over time:

  → *Participant I-4:* Change in cash flows, values of certain assets, corp. value change

→ *Participant I-17:* Annual growth rates-next two years, P/E ratios-next two years, P/E ratios vs. estimate of "normalized earnings"

→ *Participant I-10:* Capital reinvestment rates

→ *Participant I-11:* Annual sales growth rate, annual earnings growth rate, annual dividend growth ratios

→ *Participant I-12:* Five year compound annual growth in earnings, assets

♦ Do you have a standardized list of statistics that measure changes over time?

Yes (see descriptions below) 9

No 0

- Description of other statistics that measure changes over time:

→*Participant I-6:* Trends in costs, trends in selling prices, CAGR in volumes

→*Participant I-7:* Pricing, SGA, cost-of-good, ROE, ROA, cash flow

→*Participant I-11:* Sequential/seasonal patterns of change, incremental profit rates

→*Participant I-12:* The list varies with the economic cycle- emphasis on credit quality when the economy worsens and growth when it recovers.

- Questions on ratios and percentages that help you assess relative profitability, productivity, and risk:

♦ *Question 1*: Please indicate the relative significance in your work of the ratios and percentages listed in the table on the next page by checking whether you find each **Essential, Helpful, Merely Interesting, or Not Useful.**

♦ *Question 2*: Do you have a standardized list of ratios or percentages?

Yes 8

No 0

		Essential	*Helpful*	*Merely Inter-esting*	*Not Useful*	*On You List*
• Current ratio:	current assets / current liabilities	2	5	1	1	2
• Quick or acid test ratio:	current assets – inventories / current liabilities	1	4	3	1	1
• Inventory turnover:	sales / inventory	5	2	1	1	4
• Accounts receivables turnover:	sales / net accounts receivables	1	4	2	2	1

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- **Average collection period:**

receivables / sales/360	3		4	2	1

Question 7 (continued)

		Essential	*Helpful*	*Merely Inter-esting*	*Not Useful*	*On Your List*
• **Fixed assets (plant & equipment) utilization:**	sales / plant & equipment	3	2	2	2	2
• **Total assets utilization:**	sales / total assets	5	1	1	2	2
• **Long-term debt to equity:**	long-term debt / stockholders' equity	5	4			4
• **Total debt to equity:**	currrent liabilities + long-term debt / stockholders' equity	3	3	2	1	2
• **Debt to total assets:**	total debt / total assets	2	3	3	1	1
• **Times interest earned:**	earnings before interest and taxes / interest expense	3	5		1	3
• **Expenses to revenues ratio:**	expenses except income taxes / sales	4	1	3	1	3
• **Profit margin:**	earnings / sales	7	2			5
• **Return on total assets:**	earnings + interest expense–tax benefit of interest expense / total assets	7	2			4
• **EBIT return on assets:**	earnings before interest and taxes / assets	4	4	1		4
• **Return on equity**	earnings available to common stockholders / number of common shares outstanding	8		1		6
• **Earnings per share (EPS)**	earnings available to common stockholders / common stockholders' equity	9				6
• **Dividends per share**	dividends paid on common stock / number of common shares outstanding	7	2			6
• **Payout ratio:**	cash dividends per share / earnings per share	3	6			4
• **Price /earnings ratio:**	market price per share / earnings per share	8		1		6
• **Book value per share:**	stockholders' equity / number of shares outstanding	6	2	1		5

Question 7 (continued)

		Essential	*Helpful*	*Merely Inter-esting*	*Not Useful*	*On Your List*
• **Cash flow per share:**	earnings available to common stockholders + noncash expenses & write-offs / number of common shares outstanding	5	2	2		4
• **Others:.** Fully Diluted						
Total Market Value	(# shares x price) plus debt / annual sales	1				
Gross profit margin		1				2
SGA as a percentage of sales		1				2
Research as a percentage of sales		1				1
Operating profit margin						1
Tangible book value			1			1
Total debt/ tangible equity		1				1
Net Interest Margin	Int Income - Int Exp / Avg. Earning Assets	1				
Non-performing assets	Past due 90 days + Other real estate owned / Avg loans + other real estate owned	1				
Liquidity Ratio	Market Related Liabilities / Total Funding	1				
Charge-off Ratio	Net Charge-Offs / Average loans	1				
Efficiency Ratio	Non-interest Expense / Total revenue (net of interest expense)	1				

Question 7 (continued)

		Essential	*Helpful*	*Merely Inter-esting*	*Not Useful*	*On Your List*
Stable Revenues	Tot. Rev. Netted-Trading & For. Exch. / Total Revenue	1				
Earning Power	Earnings before Taxes, Credit Expenses and Unusual Items	1				
	Loan Loss Reserves / Avg. Loans + leases	1				
	Loss Reserves / Nonperforming loans	1				

[PMQI 10/16, p. 29-32]

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, an investor made a comment related to the way he uses information to achieve his objectives.

Participant I-11
As I said, there is a broader issue here. I use historical financial statements as one of the benchmarks that is helpful to me in making forecasts of future performance. What I need is to be confident that the benchmark I'm using stays the same, and I think that historical financial statements provide that sort of stable reference point. I'm not sure that it is the accountant's job to determine that [name deleted] assets were worth less than historical cost; I think that's the analyst's job. What I get from the historical statements is a determination of how management allocated assets and the subsequent outcome of those decisions; I think that gives me some guidance on the future. But if every time I open a set of financial statements of a company and it's different than the one I looked at the previous quarter or previous year, I'm at sea. So let's get away from arbitrary adjustments to financial statements to solve some imputed or imagined or perhaps real abuse we think we see, because it's probably going to create new ones. [Also included in 4] **[TI 1/13, p. 3-4]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display. During the discussion on income statement display, some investors made comments related to the way they use information to achieve their objectives.

Committee/Staff/Observer
Restructuring charges, for example, are required by the SEC to be shown above the line, before you get to operating earnings. Is that a problem? [Also included in 5(a)] **[TI 1/13, p. 27]**

Participant I-8

No, because it's disclosed. I can make whatever adjustment I want to it. [Also included in 5(a)] **[TI 1/13, p. 27]**

Committee/Staff/Observer
But you would make an adjustment to get to core earnings? [Also included in 5(a)] **[TI 1/13, p. 27]**

Participant I-8
Well, there are extraordinary charges and extraordinary charges. There are some that are really a result of some change somewhere and there are others that just reflect poor management judgment over some period of time. My guess is that management is less inclined to disclose positive items than negative items because the latter explain why they did so poorly. [Also included in 5(a)] **[TI 1/13, p. 28]**

Participant I-12
The display required for the companies I follow (banks and securities brokers) were determined 50 or 60 years ago. That display has little or no relationship to the way these businesses are run today. First of all, the average balance sheets in most intermediation companies is an absolute essential. In fact, if it were the only thing that I got, with notes on revenues and expenses, I would probably be very happy. With the income statement, I reclassify everything. I have a net interest classification, a fee and commission classification, a trading gain classification, a capital gain classification, and the ubiquitous "all other". So I restructure the income statement on an ongoing basis for the companies I do a model for. [Also included in 5(a)] **[TI 1/13, p. 32-33]**

Participant I-11
I deal a lot with distribution companies and I have some formulas that I use and that seem to work pretty well, where I drive my projection of selling expenses based on sales, and I drive my projection of G&A based on some other factors and, occasionally, my forecasts are right. I would like to see notational information about where the depreciation comes from; how much goes into costs of goods, how much goes into S,G&A. [Also included in 5(a)] **[TI 1/13, p. 33]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of databases. During the discussion, comments were made on the way investors use information to achieve their objectives.

Committee/Staff/Observer
In making your assessment as an analyst, to what extent do you weigh whether an auditor makes reference in his report to the existence of litigation? [Also included in 17(c)] **[TI 3/17, p. 27]**

Participant I-16
I would assume that if I'm doing my job, I'm aware of the litigation before the annual report is released, then I'm going to make a decision whether I think the auditor is going to qualify his opinion. If the prior report was not qualified and I think the auditor will qualify the next one, I'm going to sell the stock because I think the stock will react negatively to that opinion. Alternatively, if the stock has the negative auditor's opinion, I then might consider whether to buy it thinking that the adverse information is already in the price of the stock. The presence of a negative opinion increases your assurance that everybody knows about it and if you don't think that the case may be lost, you may want to buy the stock. [Also included in 17(c)] **[TI 3/17, p. 27-28]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of conservatism. During the discussion, an investor made a comment on the way information is used to achieve objectives.

Participant I-12
There has to be a balance between the two. I don't want a company ignoring reality in the interest of conservatism. We have all seen companies that are having terrific results through reasonably generated numbers, not flaky accounting, and the CFO decides that rather than growing 20% this year, they'll grow 16%, and sock earnings away in reserves for future years. As analysts, we will go back and make adjustments if we know that this is happening. Similarly, if things are horrible, I want to know they're horrible. There has to be a balance between the two principles and I can't say that I prefer one over the other. [Also included in 2(b)] **[TI 3/17, p. 31]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting. During the discussion, an investor made a comment on the way information is used to achieve objectives.

Participant I-12
I agree with what has been said. I would add that this gets to the essence of what analysts do in terms of constructing models. I use quarterly reports to see how a company responds in differing economic environments. You can't get the full flavor of that, in a rapidly changing environment, with annual reports because they tend to smooth out a lot of distractions. When I build my model, I take historical quarterly reports, look at what has happened in different environments, and that gives me some prologue for making assessments of what might happen under the kinds of environments I'm predicting in the future. Then I make that estimate and

track it along the way, and it becomes an early warning system and a predictive indicator. [Also included in 11(e)] **[TI 3/17, p. 36]**

Committee/Staff/Observer
Databases. We understand that investors are, with increasing frequency, purchasing databases that include information taken from external reporting. For example, those databases may include condensed financial information for a number of periods and for many companies. Do you use databases? What kinds of information does the database include and how does it help with your analysis? [Also included in 16(a)] **[TI 3/17, p. 48]**

Participant I-12
I create my own database because I have yet to find a decent database in my industry that I can buy that gives me the level of detail that I really want. I find database work extremely helpful; I can aggregate an industry, look at industry trends, a company against an industry, and all of that is the essence of our work. I understand that there's a couple of new databases that I haven't looked into that I may end up buying. [Also included in 16(a)] **[TI 3/17, p. 48]**

Participant I-16
I have spent most of my career as a generalist, which means that I have been working on companies that I haven't worked on for very long, so I don't have a database or history. So I use a database as a way to allocate my time. You can screen, using 10 years of financial statement numbers, an enormous number of companies in a couple of minutes, perhaps pop out some anomalies that are worth investigating. I wouldn't buy a stock based upon a screen because I don't know if there is enough reliability. But if it can limit the universe and enrich the likelihood of finding something good in that universe, then it's a very useful screening device. I know there are some firms that use databases to make investments, but I think most of us use them for screening purposes. It helps narrowing down my search. [Also included in 2(b) and 16(a)] **[TI 3/17, p. 48-49]**

Participant I-7
[I use databases] partly from a defensive point of view. That is, to the extent that I know that much of my client base uses databases, I will use them to protect myself. I want to know what they are seeing so that I'm not naked when I walk in. If there's a change over time of some significant ratios, I don't want to be caught without having that perspective. [Also included in 16(a)] **[TI 3/17, p. 49]**

Participant I-5
Unfortunately, a lot of them adjust in different ways. You're not certain exactly how a database treats different items. As an analyst, it takes long enough to look at a company's financial statements for the year as they're presented; to take them as they are somehow massaged in a database, it does not help you much to get an opinion on a company. Where I found databases useful is in getting aggregate numbers; for example, the median cash flow coverage ratio for all single B credits. You can get that from a database without being that far off. [Also included in 2(b) and 16(a)] **[TI 3/17, p. 50]**

Participant I-7
Databases are not an end-all; they're only one more element that you have to use. [Also included in 16(a)] **[TI 3/17, p. 50]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches.

Participant C-11
I don't personally think that there is one way to do your analysis, that cash flow, per se, is the only way to go, or that accrual accounting is the only way to go. The way that you analyze a company is going to vary depending on the business that you're dealing with, and all kinds of different things. Often, you will be using both kinds of approaches, or want to have an accrual, or want to look at good, pure cash flow. [Also included in 1(a)] **[TC 12/8, p. 9]**

I'd also say, with regard to all of the bullets in thinking about this, that there is something missing, which is more balance sheet related items. I happen to be more emphasizing in my own work on analysis of financial intermediaries, and an extremely important thing that you analyze is the trend of various loans or investments or deposits, or whatever the items may be. This seems to be missing from all of the elements here. Your trend analysis of various balance sheet items is just as important as the trend analysis of revenues or costs. The emphasis on balance sheet items also gets me into a discussion of mark to market in the sense that if you mark to market your financial statements, number one, you lose all those trends, but also you are departing from cash in the sense that your loans and investments after all do end up getting paid at a stated amount at some maturity date. And so for several reasons I think that the accrual and cash accounting tables and analysis are both important, and then secondly I think the balance sheet has to be brought into a lot more focus on these bullets. [Also included in 1(a) and 4] **[TC 12/8, p. 9]**

Participant C-14
I also want to say I'm in agreement with [participant C-11] also in that while we focus on cash in our analysis, we'll look at accrual accounting to see if the company is able to recover its costs and its pricing. And that's important, but when you start to make projections, that isn't always helpful in your projections. In your projections you start looking at, rather than depreciation on the assets that are currently on the balance sheet, you're looking at what the company is spending on new assets, and that's a better gauge by which to look at future cash flows. Accrual accounting to me seems to be a much more balance sheet kind of approach, and I'm not sure that that really ties in with projecting future cash flows very well. [Also included in 1(a)] **[TC 12/8, p. 10]**

Participant C-1
We use multiples of cash flow. So we're using earnings before taxes, depreciation, amortization, and multiples of that. The problem with determining normalized or core earnings is the amount of so-called one time charges which are always run through a company's income statement. The amount of time spent looking at pro forma cash flows or

pro forma earnings is tremendous. The number of companies selling divisions, selling plants, closing plants, or looking at buying companies and then merging them makes it very difficult for us to look at normalized cash flow and determining intrinsic value of that. [Also included in 1(a) and 5(a)] **[TC 12/8, p. 13]**

Participant C-5

Actually from the bank group population, as well, I would contrast. We are a bank lender that maybe lends a little bit down the tier of bank credit. Bank debt or any debt is really just a put on equity for the owner of the company, and we have an understanding that that intrinsic value has a lot to do in determining our success, the customer's viability, and then ultimately the repayment of our debt as expected. We do play heavily into intrinsic values, both using price earnings multiples, and then also discounting methodologies. [Also included in 1(a)] **[TC 12/8, p. 14]**

Participant C-4

We will use intrinsic value to try and determine whether or not it's prudent to allow goodwill in our analysis. For example, there has been a purchase and we are trying to determine what the value of that company is, we may use a weighted average intrinsic value calculation that used multiple of earnings, multiple of cash flows, and then about 10% or so, or a liquidation multiple. And we found that to be useful. The IRS also bought that calculation. So we felt that it was useful. [Also included in 1(a)] **[TC 12/8, p. 15]**

Participant C-3

We've increasingly gone to a concept of stressed capital where we look at the potential charge of a company's exit from a certain industry or geographic area and its impact on capital. [Also included in 1(a)] **[TC 12/8, p. 17]**

Committee/Staff/Observer

I'd like to take questions 14 and 15 in tandem. How have you standardized your process for analyzing? Particularly we're interested in sequence, that is in terms of things you do first, second, and third. One of our goals is to try to understand the base of information you accumulate before you start your analysis, what analysis you do, and then what additional information you bring to the table. The second question then asks for things like standardized ratios and percentages that are important to you, that you use as rules of thumb, or some kind of cut-off decision making, or even smell test if you will to help us understand how this standardization works. **[TC 12/8, p. 59]**

Participant C-5

Each industry group that we have within the bank have somewhat of their own process. But we have really understood that there is more standardization in all these ratios, even across industry groups. We started with six key ratios, although we found that information wasn't forthcoming on one of those, which was a consistent measure of growth or sustainable growth within a company. We initially have people put those five ratios out on a page. They quickly

shift from that to a cash flow analysis. The trend in the cash flow, the sustainability of those cash flows, and ultimately you move to a business valuation, sort of just getting a handle on what the business is worth. All of this to come up with a customer viability rating that we would assign. From there you move into your specific credit conditions, the terms you'd like to assign, a collateral analysis and the like. The ratios that we use, just a leverage calculation of total liabilities, tangible net worth. Interest ratio, a cash flow to total debt service ratio, a profit margin NITB to sales, and a current ratio for liquidity, that's sort of the foundation elements of our analysis. What we've been using recently is a combination of like a cash flow growth and a revenue growth, and some type of weighting of the two. What we have found is that if you don't have a standardized approach in place, everybody's got their own methodology. **[TC 12/8, p. 59-60]**

Participant C-13
I'll describe the process we go through, which doesn't differ a whole lot, except for what the emphasis is. We use a database when we're starting fresh on the company to generate a set of statements that produce the various standard ratios. There is a lot of emphasis on EBITDA and also EBITDA and whatever other non-cash charges you can identify. When you've got several years of this data spread going back, then the next stage is to analyze why this happened and where it's going, and what the trends are. That's where you get into the company-specific information, and where you get to the point where you're going to talk to the company about whatever turns out of that analysis. Then we've got a simple kind of Lotus program where you build in some assumptions, and you can then project that same set of information going forward, to try and produce income statements, cash flows, and balance sheets going out generally three years forward, although sometimes we try and go out to the fifth or sixth year to get an idea of what it would look like if you continued to project those trends. **[TC 12/8, p. 60]**

Participant C-6
Dealing with private companies, typically the information that we'll ask for in an initial contact is three to five years of annual statements; a current interim statement if available, some trade references, some copies of some current bank statements, and personal financial statements. That will typically get us started, and then we go into analyzing the numbers, and going into some ratio analysis and looking at cash flow, and looking at personal financial statements, looking at personal assets of the owners, and so on. [Also included in 1(b)] **[TC 12/8, p. 60]**

Participant C-16
We have a standard credit application, and because we're equipment lessors and lenders, we focus on the type of equipment to be financed and its use, especially in terms of essentiality. With respect to financial statements and spreadsheets, we focused on the four critical ingredients: profitability, cash flow, leverage, liquidity. We look a lot at ownership details of the business, especially with respect to insider dealings and leasing from principals and so forth. Personal financials and tax returns of private companies, bank and trade references, Dun & Bradstreet agency reports. We always in larger transactions speak to management to draw out some of the information that's not publicly available. For larger businesses and public companies, we would typically understand market capitalization versus book, and how debt securities trade, what their ratings are, and so forth. **[TC 12/8, p. 61]**

Participant C-4
We do basically a five step process. Number one: history, back plan, and organization review; trying to determine who is in control of the company, what the ownership structure is, what's their mission statement, what's their competitive advantage in the industry. Step number two: we'll look at their job history or their history in their line of work, and make assessments on their historic profitability. Step number three is analyzing the adequacy of their accounting presentation, understanding their finance, and understanding their internal financial reporting. Step number four is a credit review; looking at their bank covenants, looking at their credit history with various suppliers, various owners they may have worked for. And then step number five is kind of a combination of the first four steps, and then we apply certain ratios of what credit we'll extend to a customer based on financial position as of a given date. **[TC 12/8, p. 61]**

Committee/Staff/Observer
When in this five step process do you have, if ever, conversations with management to fill in the blanks? **[TC 12/8, p. 61]**

Participant C-4
Under step number one we spend a lot of time discussing with management the organization, their mission, what they feel they can do better than the competition, what the market outlook is. And we'll follow it up with annual meetings, or semi-annual meetings with our customers. **[TC 12/8, p. 62]**

Participant C-11
My comments really should be put in the context that we're not doing the very small companies or we're not doing a large amount of the high risk debt. So I'd say with that as a background we do not use a database. Our analysts are responsible for the analysis and the recommendation. One reason for being careful about a database is that we want our people to look very hard at the changes in the company, particularly when there are acquisitions that occur and divestitures, so that you know and totally understand the fact that the numbers may or may not be continuous. So we don't have a standardized ratio framework that we give to our analysts. We definitely require that if we're going to buy something, we know the management one way or another, and have talked to them about not just the numbers, but about the broader business horizons. [Also included in 16(a)] **[TC 12/8, p. 62]**

Committee/Staff/Observer
[Participant C-11], how many buy transactions might you enter into in a month? What might be an average size of an individual investment? Is that a fair question? **[TC 12/8, p. 62]**

Participant C-11
It's a fair question. In recent years it has not been what you'd call a large number, because we haven't felt the spreads are there in the corporate world. Also, you should understand that we recommend shorter term commercial papers and things like that. We have about $3 billion in bonds and $1 billion in short terms. But we're not necessarily buying a lot of new issues every week at all. **[TC 12/8, p. 62]**

Participant C-14
We do a lot of the things everyone has mentioned. We get all the historicals, we calculate maybe 50 to 100 ratios, depending on the industry, we meet with the management, and then we put the other financial forecasts. But if there is one thing that we do in every credit analysis these days is run through this analysis, which is taking EBDIT, earnings before depreciation interest and taxes, after taking out non-recurring items. Then we take out capex, working capital changes, cash taxes, dividends, interest, principal payments to try to get to what's left. And it's sort of a smell test. But you can really get a good handle on the company if you're doing the forecast and you run this number. [Also included in 12] **[TC 12/8, p. 62-63]**

Committee/Staff/Observer
What do you label with what's left? What do you call that? **[TC 12/8, p. 63]**

Participant C-14
Net cash flow. **[TC 12/8, p. 63]**

Committee/Staff/Observer
Net cash flow? We'll come back to this later, you said you put together your own financial forecast? **[TC 12/8, p. 63]**

Participant C-14
Right. We put together a five year financial forecast, principally because first of all managements provide us with their forecast, and we like to compare ours against theirs. But also because it forces you to consider and assess the debt maturities. [Also included in 12] **[TC 12/8, p. 63]**

Participant C-15
We obviously do things in a very similar way. But in looking at forecasts, we look at management forecasts and then our own forecasts. But also importantly, we would do comparisons for management forecasts with one company versus how other companies in the same industry, how do they view their industry going forward. And over time you can build up a certain track record of which companies are consistently optimistically and overshoot, and which ones have unrealistic assumptions and so on. I think a lost can be done I guess both prospectively using comparative analysis, and also retrospectively, how has a company done versus its competitors, because just looking at the numbers in a vacuum or ratios in a vacuum may not tell you all you really want to know. [Also included in 12] **[TC 12/8, p. 63-64]**

Committee/Staff/Observer
The information you have with respect to competitors or co-people in the industry, do you feel that that's information you've gotten because of your situation as an insider? **[TC 12/8, p. 64]**

Participant C-15
Most definitely, yes. **[TC 12/8, p. 64]**

Committee/Staff/Observer
It's not information you would have otherwise had, it's because you sit where you sit? **[TC 12/8, p. 64]**

Participant C-15
Essentially, yes. I think maybe [participant C-12] might have access to a lot of the same information, advising companies how to deal with us and so on, but that also makes you an insider certainly. On the buy side, I think there's a lot lower level of information. **[TC 12/8, p. 64]**

Participant C-12
Although I'll throw out one thing that we've been talking about which is that we've observed over time that rating agencies have become more insiders than just about anybody else. And that one of the things which is of interest to us in the due diligence is what is of interest to you (rating agencies) in the rating. What are you sensitive to? What are you commenting on? Because you get more detail than we do. On the subject of ratios, the ratios we look at have varied over time, leaving something of a cyclical element to that. The emphasis has changed over time. **[TC 12/8, p. 64]**

Participant C-1
We spend a lot of time understanding management and what management's intentions are, and then also analyzing who owns the company and what their intentions are. The only additional thing probably in our ratios is we will quite often mark the capitalization table to market, primarily looking at what type of multiple of cash flow, or multiple of earnings are we buying those securities and what's ahead of us. **[TC 12/8, p. 65]**

Participant C-5
I sit on a credit committee and I'm probably one of the few people that still believes in projections. Everyone else has been so soured by the hockey stick of the past, and the lack of any kind of realism in the projections, that everyone has pretty much said give me the old, the historical, and I'll make my own set of projections out of this. Everybody that sits around the committee has already put their own particular view on what's going to happen. Personally, I don't care what we (the bank) think, but more what does the company actually think, and where do they really project they're going? One of the big issues we as a bank are wrestling with is that we get so much that we do get information overload, and we don't use the information effectively. Some of this abundance of information may ultimately just compound that problem instead of helping satisfy it. [Also included in 12] **[TC 12/8, p. 65]**

Participant C-15
I think it's more an issue of analysis than the information. **[TC 12/8, p. 65]**

Participant C-9
Sometimes you want to be applying the same filter so you can see emerging problems, and to make sure that you're not putting your own bias on the situation. I'm in the situation of covering 100+ companies, so I'll be getting the basics of the annual, the 10-Qs, looking through, and evaluating the key ratios. . . .Also I look at public information, what's in the

news, what investors may be looking at currently as a way to gauge the current thinking. **[TC 12/8, p. 65]**

Committee/Staff/Observer
The last two questions, 16 and 17, deal with future and forward looking information. I would like to take these separately. What kind of future or forward looking financial information do you prepare? That question deals not just with whether you do X periods forward or if you prepare them at all, but what is the purpose in doing those forward? [Also included in 12] **[TC 12/8, p. 66]**

Participant C-7
From our earlier discussion, the point was fairly well made that you just don't focus on cash flow or the income statement or the balance sheet, it's that mix of all three elements that you're looking at, with the goal of are they going to be there, are they going to service our debt? Generally we don't go beyond three years forward. **[TC 12/8, p. 66]**

Participant C-15
Most of the companies that we deal with that provide forecasts go out five years. But I think the credibility goes off dramatically after the second year; certainly beyond the third year it is real problematical as to how much weight you put on anything like that. [Also included in 12] **[TC 12/8, p. 66]**

Participant C-11
The people that do our recommending are both equity and bond analysts. For equity purposes, we project earnings and normalized earnings growth, and things like that. But in terms of our bond horizons, we want to have the comfort that under a variety of economic and specific company circumstances over whatever, five, ten, or whatever the bond might be in years, we are reasonably confident that the company can pay its obligations in recession conditions, or whatever might go on. I'm giving a more general answer rather than saying that we try to project specific numbers year by year. **[TC 12/8, p. 66]**

Participant C-13
In preparing these projections, what you want to look for is to see whether these things hang together, and make some kind of logical sense. In other words, in order to service their debt, their cash flows have to grow at a certain rate, what does that imply, and can you produce a credible case that will happen? Or do revenues have to increase at 25% a year in order to do it? If you've go a model that suggests that that's what's got to happen, clearly that's an unlikely circumstance. You project in a relatively mechanical fashion, but with a set of assumptions that are the result of your analysis of what's happened in the past and your conversations with the management and your knowledge of the industry. Then you see whether it all makes some logical sense. **[TC 12/8, p. 67]**

Committee/Staff/Observer
How far do you go out, [participant C-13]? **[TC 12/8, p. 67]**

Participant C-13

Formally for three years, but sometimes we make a pass into the fifth or sixth year, particularly if there is a large number of maturities or something out in the fifth or sixth year. You're looking for the ability to be able to service that. **[TC 12/8, p. 67]**

Participant C-1
What we do depends on where we are in the capital structure, and whether we have equity upside or not. There are two parts; one that's more of a stress test and can the company self-finance, and we will go out easily five years, and sometimes as much as seven or eight years. Granted, those out years are kind of meaningless numbers to some degree, with very conservative and even flat numbers. We throw recessions in. If we have more equity upside, then we're looking at earnings growth and earnings per share and trying to forecast that out. But from a fixed income perspective, it's really a stress test more than anything else. **[TC 12/8, p. 67]**

Participant C-5
For either the acquisition type transactions, which have been a big part of our institutions three, four years ago, and then a lot of project finance where we do specialized industries with large capital investments, the cable businesses or transportation type companies, we do go out ten years on a horizon in a DCF model. But for our normal debt horizon is about seven years, five to seven years, so you really have to get out past scheduled maturities and bank debt to make sure, and you want a little bit of time beyond, because invariably there are assumptions that we have the ability to extend or push back a little bit if there is some softness in the assumptions. The real issue here is not to buy into the projections, but to see how fast they have to project some revenue growth assumptions to meet all the hurdles. If they can put it all together and do it with a 2% revenue growth, you feel pretty comfortable. If they've got to pencil in a 25, then all of a sudden you get a little concerned. It is a situation where you want to schedule your maturities as soon as possible with a realistic growth assumption in the business. So we used ten years. Some of that's borne out of real estate as well, real estate is a ten year cycle automatically whenever you look at real estate project finance. **[TC 12/8, p. 68]**

Participant C-10
My comments would harken back to lack of segment reporting. It's very difficult to really forecast much. In fact, being a debt analyst, we're really more concerned about the downside, and so I would have to use some sensitivity analysis to make sure that the fixed charges could be covered, and that there is an ongoing concern. But I'm not as concerned about the upside. [Also included in 3(a)] **[TC 12/8, p. 68]**

Participant C-10
I moved over to high yield bond about five, six years ago from equity. When I first came over there, I didn't understand why they were projecting five years out. Now I'm very much a supporter of using five years, which is what we do. But on the equity side, one year is about everybody's extreme that they will go out. There is a big difference there; the volatility is greater on the equity side. Here we're trying to protect the downside, or at least anticipate the downside. There is no answer that says that five years are going to be right, but at least you want to try to understand whether you're covering the minimum types of coverages. I support

all the different comments that people have made, but cash flow and EBIT-DA is the main tool that we use to understand whether or not there is coverage. **[TC 12/8, p. 68-69]**

Committee/Staff/Observer
The second question follows (question 17): should companies provide estimates of future cash flow earnings or financial position? If those estimates were provided, would they eliminate the need for you to do your own calculations? And if not, please distinguish how you would use company provided estimates in contrast to your own estimates? [Also included in 12] **[TC 12/8, p. 69]**

Participant C-11
I think that any company estimate of some sort of five year earnings growth, or something like that, or for that matter any of the ones that I've seen in private placement basis, are definitely being taken with huge grains of salt, and relatively speaking, ignored. I mean it's dangerous for a company to put precise longer term estimates on anything because things aren't going to work out the way you might think, and it's just a way to get sued. Any forward looking information should be put in the context of goals and the very important things that company management should do in their public disclosure is to set out broad business oriented objectives. Do they want to get into this area or that area, and are the prospects in a general sense good or not as good as they had been, or whatever. And also some financial ratio guideposts in terms of goals for return on assets, or equity, or capitalization ratios. So I think some information can be given that gives people a sense of the future. [Also included in 12 and 13] **[TC 12/8, p. 69]**

Participant C-4
Most of our contractors don't prepare this type of information, and in some instances they're using the information we give to them. But it would be helpful, I think, as a discipline for them to make some projections with maybe the help of their CPA, and then compare themselves at year end. It would mean more management information they could use, and that we could look at, and they could give us in their financial statements a projection of where they're going to be. Then at the end of that year we could look at where they actually were in comparison to that projection, and question them probably in some very specific areas that we otherwise might not be able to have that information on, trying to determine why they didn't meet what they hope they would meet. [Also included in 12] **[TC 12/8, p. 69-70]**

Participant C-3
I would emphasize the qualitative factors in reporting as to whether or not the past is indicative of the future. Case in point: We've had a very favorable yield curve environment here in the U.S. and bank margins have risen sometimes 100 basis points in the last four quarters. Do you expect that that will continue? I don't think that putting projections in financial statements meets anyone's needs. I agree with you, [participant C-11]. I also think that there is a danger involved in putting numbers in financial reports about the future. [Also included in 12 and 13] **[TC 12/8, p. 70]**

Participant C-13
I'm opposed to having companies publicly make estimates about future earnings and cash flow. I guess for three reasons: one would be if there is one area where we don't need information

overload, this is one, so we can eliminate that potential information overload question. The second would be that I believe they lack credibility and reliability. And the third would be the temptation to game the numbers. I mean having once predicted a certain amount of earnings or cash flow or whatever it might happen to be, 12, 24, or however many more months out you're talking about, the temptation to game the numbers becomes extremely strong. Finally I might say that maybe it's preempting the job of the analyst, too. [Also included in 12] **[TC 12/8, p. 70]**

Participant C-12
I would certainly never stop me from doing my own projections just because the company has got something in its reports. And generally I'd rather see the type of thing that [participant C-11] was talking about. If management has a number or a concept or a philosophy that they're managing to, I'd like to know that. That's important. Historically, most management that I've seen terrible at projecting; the projections I've seen going out any length of time are pretty simplistic and pretty poor. One thing that is of value is certain negative information. Do these guys really think that they have so much revenue growth that they don't have to do a better job than this controlling expenses? Do these guys think there is so little volatility in the world that this is the kind of leverage they think they can get away with? So there's that kind of negative value, but that's about all I see. [Also included in 12 and 13] **[TC 12/8, p. 70-71]**

Participant C-5
I don't agree with providing projections in the public financials and with auditors contributing to those in a published financial statement, even for a private company. We do get projections, we wouldn't do any term finance without projections. Any credit greater than a year, we require projections. We do a separate bank case which is our own assessment of that and which is much more a downside analysis. What we do use them for are two key purposes. One is management is forced to reconcile their ability to do certain things in the future such as capital expenditures. We don't have to worry about two years from now management coming back and in and wanting to discuss a dramatic new capital expenditure program, because we've had an adequate discussion of those items well in advance of that. A second item and what we really do use management projections for is we tie our fences right off of that. Every covenant is tied just off of management numbers. So whether they want to be optimistic and rosy and put a 25% sales growth in there, we'll be just under them at 24% with our hurdle. And when they come back in, we'll charge them default rate pricing until you get that corrected. Projections are a valuable tool, and we wouldn't ignore them, but we would end up discounting them just like we discount managements' projections if they came from an auditor and would be part of the financial package. It would add to cost, it wouldn't add to value, necessarily. There are pieces of current historical information with more detail that would allow us to make our own judgments about those projections which are not adequately disclosed, like capital expenditures. That's what we need to do our analysis better. [Also included in 1(b), 12, and 17(b)] **[TC 12/8, p. 71-72]**

Participant C-1
I would not be a big supporter of projections. I agree with the comments that managements are terrible at making projections. Most buy-side analysts could probably get within 5% of five year cash flow; it's just not that complex. Projections have been of some help in companies that are rapidly growing. A good recent example would be [name deleted] that's

adding 75 stores a year, and there it's very difficult to come anywhere near accurate projections. The other thing has already been brought up; the risk of not meeting projections provides substantial downside price action on bonds, much more than is warranted. And finally, quite often projections have a tendency to be more detailed and you're never able to reconstruct them in the future anyway. So they're not really that worthwhile. [Also included in 12] **[TC 12/8, p. 72]**

Participant C-10
Sometimes we will get a company giving us a private placement, and then they'll put in a second package their projections. And first we're given the choice of do we want it, or sometimes they'll mail it, we'll mail it right back, because we don't want to be tied down. So we'll just work with the document that doesn't have the projections, and say we don't want it. Because otherwise we end up signing a letter of confidentiality, and our lawyers give us all sorts of hassle about how long that says we're tied down. There is a big issue here legally in terms of how far are you tied down and when are you released? [Also included in 1(d), 12, and 18(b)] **[TC 12/8, p. 72]**

Participant C-7
From a bank creditor's standpoint, the companies we're dealing with have very simple capital structure. You've got your typically privately-held company, you've got your owner's equity, and we're their other source of capital, we're their capital market. In that case, we want to see projections. It's essential for us. [Also included in 12] **[TC 12/8, p. 72]**

Committee/Staff/Observer
When you get those projections, then, what do you do? [Also included in 12] **[TC 12/8, p. 73]**

Participant C-7
Typically we'll take the historicals and almost do a variance analysis. What are the points of departure? What's changing, why do you think it'll change, and then we try to assess how likely or how realistic those assumptions are. [Also included in 12] **[TC 12/8, p. 73]**

Participant C-2
This is where a wide user body does have different views on this issue. As a banker, particularly dealing with smaller and in many cases privately-held companies, I do like to get those projections. I use them in much the same way as [participant C-7] does, trying to understand how I think they will or won't be met, make some judgments about management's ability even to put together a forecast, in some cases. And definitely use them to look out over a period of time to project future borrowing needs, whether or not we're going to be willing to make additional loans in the future, given what we're looking at as a financial condition and structure. And we do use them. We use management's as a starting point, and tweak them as we feel appropriate based on our own observations. [Also included in 12] **[TC 12/8, p. 73]**

Participant C-16
I heard different people use them differently, but I didn't really hear any consensus that we want to see them in the financial statements. I mean if we're going to make a loan to a cable system, clearly we want to have projections, and we'll get that in the ordinary course of our

due diligence. But I didn't hear anybody here say they wanted to see them in standardized financial reports. [Also included in 12] **[TC 12/8, p. 73]**

Committee/Staff/Observer
Does everybody agree that management's projections should not be in the financial statements? [Also included in 12] **[TC 12/8, p. 73]**

Group
Yes. [Also included in 12] **[TC 12/8, p. 74]**

Committee/Staff/Observer
Now, let me go back to both [participant C-16] and [participant C-2] and [participant C-7]; since you do get them on the initial credit, do you then get them periodically thereafter? [Also included in 12] **[TC 12/8, p. 74]**

Participant C-16
By agreement, yes. [Also included in 12] **[TC 12/8, p. 74]**

Participant C-7
Same situation. It's negotiable. [Also included in 12] **[TC 12/8, p. 74]**

Participant C-2
In most cases, I do get them in the normal course of receiving the financial statement each year. They're supplemental information that we try to get. We don't always get them after the deal is done, but we try to. [Also included in 12] **[TC 12/8, p. 74]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 3

b. If you estimate "intrinsic value", how do you determine the value of the company as a complete entity? (Please check each box that applies.)

•By applying a price-earnings multiple or discounting normalized or core future *earnings*	**5**
•By applying a price-earnings multiple or discounting normalized or core future *cash flows*	**6**
•By using the current trading price of the company's public securities, if available	**3**
•Some other method (Please describe)	**2**

Participant C-3 - By estimating the current impact, on book value, of differences between borrowers in the same industry group, and then evaluating price/book ratios. The differences usually arise from inconsistencies in accounting application, *e.g.*, postemployment benefits, or difference in loss reserve adequacy.

Participant C-14 - Do not use.

Participant C-15 - Do not compute. Cash flow is the basis of an analysis.

Participant C-4 - Weighted average model, combining earnings, cash flow and liquidation value:

7 year earnings multiple	50%
7 year cash flow multiple	40%
Adjusted (FMV) net assets	10%
Weighted average	100%

Participant C-18 - N/A

Participant C-11 - Multiples of cash flow of earnings can be used, depending on he industry involved, as can multiples of book adjusted for various matters. As a creditor, my first defense is the ability of this company to meet its obligations from internal resources. Only as a last resort would I want and depend on the sake of the company in total, or its piecemeal sale, to pay this debt obligation.

Participant C-9 - Relative valuation.

Participant C-16 - Consideration of premium value which a motivated buyer may pay for competitive position, etc.

Participant C-2 - *Changed "If" to "When" on the question. Regarding bullets #1 and #2:* Depending on the industry. . . *Regarding bullet #3:* Rarely applies. *Regarding Bullet #4:* Appraisals of fixed assets and/or real estate.
[PMQC 12/8, p. 9-10]

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of goodwill. During the discussion, comments were made on creditors' objectives and approaches.

Participant C-5
There is also, though, a return on assets type of issue that, yes, you're paying up, you're reducing your return on assets. But ultimately, you're buying an asset that will give you an effective return for a period of time. And your net worth is over-stated for return on assets. I will tell you where we make the adjustment is in the leverage calculation. There are other financial analytic ratios where we don't. We don't do a return on tangible assets. We just do

the quick and dirties, which are cash flow and leverage. [Also included in 7(a)] **[TC 2/2, p. 45]**

Participant C-13
I would say we do much the same thing that [participant C-5] does, that we're excluding good will, but we're looking at the net worth calculations. Also, we're looking at cash flow calculations. On the other hand, although not exclusively, because we do look at returns of tangible equity. But as a general rule, we're looking at returns on book equity, returns on book assets. [Also included in 7(a)] **[TC 2/2, p. 46]**

[Background] *The Financial Industry--Banks, Thrifts, Insurance Companies, and Securities Firms* is the second in a series of AIMR Industry Analysis seminars and proceedings. The series was conceived by Charles D. Ellis, CFA, to provide educational material on the nuances of individual industries from the perspective of security analysis. . . . Each seminar is built around an analytical framework that identifies the key factors to consider in conducting an effective analysis of the industry and that highlights the specific interrelationships that underlie sound valuation decisions. . . . The speakers at the seminar, whose presentations this proceedings reproduces in full, are among the leading specialists in financial services industry analysis. **[AIMR FINSER INDUSTRY, p. i]**

[For the banking industry,] once usable and appropriate data are generated, valid peer comparisons are possible, and Nagle[1] says the most useful peer group comparisons are market indicators, profitability measures, net interest margin, operating efficiency, noninterest revenue, capitalization, asset quality, and asset composition. He applies this concept by comparing the relative attractiveness of a regional bank not only with its peers in the area but also with all banks of like size and with the median for all national banks. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 2-3]**

In selecting bank stocks to structure a portfolio, Schmidt[2] uses a process that first evaluates the national economy and then looks into regional factors, including business growth prospects and the regulatory environment. Within the national overview, emphasis is on the economic growth outlook and on the interest rate forecast. Schmidt argues that banks are related to the economy, but only in one direction--down. A healthy economy can mean higher bank earnings, but a bad economy, or a weak segment within the economy, will cause poor profits. Comparisons indicate that absolute bank stock performance is inversely related to interest rates, but taken relative to the S&P 500, the correlation between bank stock prices and interest rates disappears. This suggests that the correlation is a market effect. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 3]**

Important regional factors in the valuation model are growth prospects, asset values and credit quality, and the banking environment. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 3]**

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[1] **Reid Nagle, President, SNL Securities**

[2] **James K. Schmidt, CFA, Managing Director and Chief Investment Strategist, Freedom Capital Management**

In analyzing loan portfolios for banks and thrifts, Pringle[3] suggests examining category definitions and exactly what types of loans are included in each category, geographical and industry exposures, and the 10 largest credits. He then discusses analytical approaches in evaluating the loan portfolio. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 3]**

Pringle observes that an analysis of nonperforming assets is applicable both to banks and to thrifts. This analysis should focus on nonaccrual loans, renegotiated loans, 90-day past due and accruing loans, and other real estate owned. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 3]**

Seifer[4] identifies a number of issues that are basic to understanding past trends and possible future developments in the insurance business. Evaluation of the investment portfolio and cash flow provides an important financial health measure of the organization. Companies are attempting to emphasize portfolio liquidity and quality for the benefit of policyholders and stockholders, and those firms with positive cash flow are in a position to reduce problem assets as a percentage of total assets. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 4]**

Seifer says reserves are the most important factor in the analysis of an insurance company and pleads with the companies for more complete data on their reserve status. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 4]**

The common belief is that all an analyst needs to know about the external factors that affect insurance stock prices is this: Premium rates up, stock price up; interest rates down, stock price up. Frinquelli[5] explains that there is much more to know, including the effect of changing interest rates on the balance sheet, the income statement, and ultimately on the trend in book value. Also, inflation must be considered, because liabilities are cost-based, not dollar-based. Inflation also is a vital element to be considered in analyzing medical care lines. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 4]**

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[3] David N. Pringle, Managing Director Furman Selz Mager Dietz & Birney, Inc.

[4] David Seifer, CFA, Vice President, Equity Research, Donaldson, Lufkin & Jenrette Securities, Inc.

[5] A. Michael Frinquelli, CFA, Managing Director, Salomon Brothers, Inc.

Additional external factors Frinquelli considers are catastrophes, particularly their size, number, and type; regulation, including the possibility of an eventual federal layer of supervision; the extent of product diversification; the matter of asset quality; changes in demographics; and the impact of consumerism, as evidenced by the passage of California's Proposition 103 in 1988. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 4]**

Cope[6] is of the opinion that analysis of a property/casualty company's operations has two key elements--a loss-development analysis and an analysis of investment income. **[AIMR FINSER INDUSTRY, p. 5]**

[W]hen paid losses rise faster than earned premiums, the fundamental profitability of the company is under pressure; in some cases, substantial increases in reserves are signals of potential problems; and as in other financial businesses, cost control is getting increased attention. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 5]**

Three factors are cited as determinants of investment results, namely cash flow, interest rates, and investment policy. Cope[6] adds that many people believe cash flow is the key in trying to time the underwriting cycle: When cash flow turns negative for enough companies or for the industry as a whole, better pricing is in the offing. In fact, however, many companies now are experiencing cash flow squeezes or even negative cash flow, thus far without any effect on industry pricing. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 5]**

[According to] Zerbarini,[7] [t]he key ratios most analysts use in evaluating insurance stocks are price-earnings ratios, price-book-value ratios, and dividend yield. Zerbarini warns that the components of these ratios and thus the quality of both must be carefully appraised to avoid wrong conclusions about value. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 5]**

According to Liss,[8] industry fundamentals may not make brokerage stocks particularly attractive investments over the long term, but in the short run, they present significant moneymaking opportunities. He offers five key elements to consider in the valuation of brokerage stocks: fundamentals; technical factors; emotional factors; business segment appraisal; and retail, discount, and institutional considerations. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 6]**

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[6] Anthony T. Cope, CFA, Senior Vice President and Partner, Wellington Management Company

[7] Donald G. Zerbarini, Analyst, Lord, Abbett & Company

[8] Samuel G. Liss, Director, U.S. Research, Salomon Brothers, Inc.

[Accordingly to Nagle,] for financial institutions, unlike companies operating in other industries, the process of analyzing and interpreting financial condition is similar both from the credit and the investment standpoint. In fact, because the market has come to realize that in highly leveraged financial institutions the safety and soundness of an institution is paramount, the interest of credit analysts
and investment analysts are frequently the same. An investment analyst needs to evaluate the financial strength and well-being of the company and relate that to its market pricing. The analyst needs to examine both the economic value of a company and its market value. A buy signal occurs when the market value falls substantially below the economic value. A sell signal occurs when it is substantially above the economic value. No other industry that [Nagle's] aware of has greater investment potential, both for profit and for loss. **[AIMR FINSER INDUSTRY, p. 25]**

[According to Schmidt, they] have developed a process [they] use to select bank stocks and structure a portfolio. The process involves first understanding what is going on in the national economy. Then, [they] look into regional factors--economic growth prospects and the competitive and regulatory environment for banking. [They] then develop and maintain a model portfolio. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 42]**

[According to Schmidt,] the health of a bank can be assessed by analyzing various categories of a balance sheet and how loans flow in and out of the various categories. **[AIMR FINSER INDUSTRY, p. 46]**

[According to Pringle,] the best way to analyze [bank or thrift] revenues, regardless of the industry, is to look at price and volume. Margins represent pricing; earning assets represent volume. This approach makes estimating earnings on the basis of historical data much easier. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 53]**

Expense ratios, used to figure out how efficient a financial institution is, must be analyzed differently for banks and thrifts. Thrifts look at interest expense as a percent of earning assets. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 54]**

[Accordingly to Frinquelli,] company valuation depends on a variety of internal conditions and considerations, including competition, volume, surplus and return management, and loss reserves policies. For a property/casualty company, the important considerations are what it writes, where it writes it, and how it writes it--or to put it another way, product, geography, and distribution. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 73]**

Analysts must evaluate the quality of [insurance company] management. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 75]**

Interest rates are important to investors because changes have a direct impact on an insurance company's market value. Most insurance company stocks are driven by mark-to-market book value rather than a given year's operating earnings. Marking to market essentially means marking the bonds to market. When interest rates go down, investor wealth accumulates, because the value of the bonds--which often represent three-quarters of an insurance company's assets--goes up. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 75]**

Analysts should also compare the growth of written premiums with the growth of expenses. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 84]**

The expense ratio is a basic measure of the company's efficiency. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 84]**

[A]n analysis of operations [also] addresses investment income. Investment income is determined by three factors: cash flow, interest rates, and investment policy. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 84]**

A simple approach to analyzing and projecting cash flow is to equate operating cash flow, excluding proceeds from sale or maturity of investments, to written premiums less paid losses and expenses. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 84]**

Analysts should carefully scrutinize a property/casualty company's reserves. The most comprehensive information on reserves is found in Schedule P of the annual statement each company must file with state insurance regulators. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 86]**

One common way of analyzing reserves is to review the relationship between paid and incurred losses and how that changes over time. Changes in the ratio can provide valuable insight into the company. This is known as the ratio of paid to incurred loss. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 88]**

Changes in these reserves patterns can provide analysts with some clues about the future. **[AIMR FINSER INDUSTRY, p. 88]**

[According to Picoult,[9]] the following items are critical in analyzing the balance sheets and income statements of life insurance companies. The mix of assets compared to industry averages is important, but a mutual company should be compared against the mutual segment of the business, a stock company against the stock segment, and so forth. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 97]**

[9] Myron M. Picoult, Managing Director, Senior Insurance Analyst, Oppenheimer & Company, Inc.

The proportions of volatile and nonvolatile assets are also important--specifically, noninvestment-grade (junk) bonds and problem mortgages compared to the rest of the portfolio. NAIC categorizes insurance company assets into six grades according to quality. Categories one and two are considered investment grade, and three through six are considered to be, in varying degrees, questionable or impaired assets. [Picoult] relate[s] the noninvestment grade-issues to a company's statutory surplus, and include[s] the mandatory securities valuation reserve. [Picoult] also [tries] to get specifics on private placements and what portion of the portfolio they represent. Analysis of private placements should be similar to the analysis of publicly traded bonds. In many instances, the private placements are of better quality than some of the public debt. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 97]**

Reserves must be analyzed [according to Picoult]. Insurance companies must set up various types of reserves, and analysts should be able to get those figures from the companies on a quarterly basis, although companies provide only annual data. [Also included in 1(b) and 11(a)] **[AIMR FINSER INDUSTRY, p. 97]**

[According to Picoult,] the revenue mix is the most important item on the income statement. Analysts should determine what portion is premiums, what portion is net investment income, and what is "other" income. The sources of the other income figures are important. For example, the company may have separate operations or subsidiaries that generate other income. For many holding companies, just determining what they own is difficult; the information may be buried in the other income category, and sometimes it is worthwhile to go digging. [Also included in 1(b) and 5(a)] **[AIMR FINSER INDUSTRY, p. 97]**

Premium mix is important. Analysts should determine the mix of ordinary life, annuities, group, and individual policies. They should determine whether the health component is a health maintenance organization or traditional indemnity and to what extent it is experience rated. A certain persistency factor relates to each of these lines of business, which should provide some information about the consistency of the company's revenue flow. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 97]**

Analysts should examine both first-year and renewal premiums. The bulk of the premiums for an insurance company are renewals. A dropoff in sales does not necessarily translate into an immediate diminution in premiums. If people are pulling back in the marketplace because they do not like the current pricing, that is not necessarily a negative. If as they are pulling back they clean up and restructure their insurance plan, that could prove to be positive if it enhances persistency net of business being lapsed. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 97]**

Net investment income has become an increasingly important and sensitive factor because it is a big number for most companies. Analysts should determine the average yields the company is getting on the various types of assets in its portfolio. In addition, they should look at the maturity of the bond portfolio. How much has come due or is coming due? This is a particular problem in the current interest rate environment. For example, because of the concerns being raised by rating agencies today, many life insurance companies are forced to keep a bigger chunk of their asset base in short-term instruments. With the rather precipitous

drop in short rates, many of these companies have suffered a double hit. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 97-98]**

Loadings are important as well. Analysts should determine to what extent companies try to adjust for changes in mortality, expense, and morbidity experience. They should also evaluate how timely the companies are in making the adjustments. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

Expenses are absolutely critical to the evaluation of an insurance company. Trends in expenses are particularly revealing. Analysts should evaluate any successes companies may have had in trimming their expenses and to what extent they could become more efficient. That is one of the key factors that will separate successful companies during the coming years. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

Finally, pricing is an important factor in the valuation of insurance companies. Is the price of insurance going up, sideways, or down? [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

An insurance company's total mortgage and real estate exposure relative to its invested asset base is important. . . . [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

At a minimum, a company's holdings should be compared against some industry standard. The American Council of Life Insurance publishes quarterly industry data on real estate holdings. Analyzing the data for a company can provide valuable clues about its strength. For example, the geographic spread may indicate where economic problems are occurring and what the company's mortgage exposure is in those areas. Similarly, the mix of the mortgage portfolio among apartment buildings, strip shopping centers, convention facilities, hotels, office buildings, and so forth provides valuable information on the potential problem areas for the company. Different types of facilities have different delinquency rates, and knowing whether the company has more or less exposure to delinquency risk is important. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

Another helpful piece of information is the average size of a company's real estate loans. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

...

The lease maturities are also an important consideration, particularly if the asset-type mix or the geographic locations of the mortgages are a concern. Analysts should examine the mix of maturities and determine whether the leases are subject to an increasing rate of rollover during the next few years. Clearly, the sublet market is obfuscating some of the trends in rental rates. Although the sublets may be stabilizing, the key point is that when a mortgage was first made, a certain rental rate was assumed to be needed to service that mortgage. In many instances, the rental rates prevailing now would not be sufficient to cover mortgage service. That explains the writedowns and adjustments in property values. Not all mortgages are bad, but some obviously will have to be adjusted. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

If maturity seems to be a problem, analysts should find out as much as possible about the tenant mix. Are the tenants strong or weak? What kinds of corporate entities are involved? Is it an industry going through a shrink mode? Is it an industry that is holding its own? A sizable exposure to tenants that are in the financial services business will be viewed differently today than it was two or three years ago, because that industry is going through a certain amount of shrinkage. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

The types of mortgages written are also important. For example, analysts should determine whether the company writes bullet mortgages, and if so, when they come due. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98]**

Analysts should examine the specifics of any mortgage foreclosures, restructurings, and delinquencies. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 98-99]**

All of this information on real estate holdings should be related to statutory surplus, because GAAP surplus is not a meaningful number. Regulators and rating agencies look at statutory, not GAAP, numbers. The statutory numbers are supposed to back up fluctuations and pick up any shortfall that might occur. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 99]**

Once a company's mortgage holdings have been examined, analysts should look at the reserves the company has established. How much? How are they being funded? Over what period of time? Setting up appropriate reserves is not an easy thing to do. Not every problem mortgage is going to be worthless. Most mortgages have some value, in contrast to some construction and development loans. Nevertheless, some type of reserve must be set up to cushion some of the loss in value. Insurance companies differ widely in how they set up loss reserves, if they do at all. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 99]**

The two important leverage ratios are surplus to invested assets and surplus to total assets. In calculating leverage ratios, [Picoult] use[s] the statutory data. The mandatory securities valuation reserve can be included or excluded, as long as this is done consistently. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 99]**

Some interesting nuances differentiate the leverage relationships for the different segments of the industry. For example, for the mutual companies, the average ratio of surplus to total assets is about 4.6 percent; for stock companies, it is about 8.2 percent. These ratios have been tracked historically for each segment of the business to see how volatile they have been. The ratios for the stock and the mutual segments of the business have been fairly consistent. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 99]**

The makeup of statutory surplus is becoming increasingly critical. Analysts should determine whether any subsidiaries are included in the surplus number. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 99]**

The advent of risk-based capital standards, according to which companies must allocate surplus by business line, is leading to some interesting if not difficult situations. Companies are beginning to complain about this requirement, because it focuses attention on their surplus. People are looking to see if, for example, some type of surplus note is involved--and, if so,

whether the surplus is questionable or clean. The cleaner the surplus, the better off the investor. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 99]**

[According to Zerbarini,] the key ratios analysts use in evaluating the insurance business are P/Es, P/Bs, and dividend yield. Comparing earnings ratios for insurance stock entails several caveats. For example, the earnings element of the equation should be examined carefully. Insurance company earnings have only been defined on a Generally Accepted Accounting Principles (GAAP) basis for approximately eight years. Prior to that, many formulas were used. **[AIMR FINSER INDUSTRY, p. 104]**

Price-book value is a good ratio to examine, but be careful how the book value is determined--whether or not it is all tangible book value. Also, definitions of book value are not necessarily comparable across all segments of the industry. **[AIMR FINSER INDUSTRY, p. 104]**

Analysts also should pay particular attention to the growth of a company's first-year policy sales relative to renewals. An insurance company can show increasing premium income or earned premiums at the same time they show a declining first-year sales trend. **[AIMR FINSER INDUSTRY, p. 104&106]**

Persistency is another important factor. Persistency measures how long the business stays on the books once it is sold and how long it feeds the company premium volume. Usually, during the first 12 to 18 months of a life insurance policy, persistency is fairly low. The buyers are keenly aware of the price they are paying for the policy and the sacrifice they are making for an intangible commodity. An advantage of new sales is that the insurance company gets fresh underwriting information on that risk, so the disadvantage of low persistency is offset somewhat by the improvement in aggregate underwriting experience. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 106]**

The loss ratio is an important factor in analyzing an insurance company. The loss ratio is the relationship of all of the losses the company is paying out currently, plus the loss reserves it is adding. Paid losses and loss reserves both are related to earned premiums. If we add the loss ratio to the cost of booking that business, mainly commission expense, the sum of the loss ratio and the expense ratio equals the combined ratio. One of these component parts relates to earned premiums and the other relates to written premiums, which effectively gives consideration to the cost of new business. [Also included in 1(b)] **[AIMR FINSER INDUSTRY, p. 106]**

Focus Group Comments, Analysts: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 1(b), 2(a), 2(b), 2(c), 4, 5(a), 5(b), 5(d), and 13] **[KPMG BANK STUDY, p. 39]**

- Desired detailed information underlying fair value estimates so they could compute the fair value themselves and compare the results to other institutions [Also included in 1(b) and 4] **[KPMG BANK STUDY, p. 39]**

- Preferred detailed information that would allow them to perform their own calculations [Also included in 1(b) and 4] **[KPMG BANK STUDY, p. 39]**

One of the objectives of financial reporting is to provide information to analysts, investors, creditors and others that is useful in making investment, credit and other financial decisions. The questions in this section relate to the analysis of financial information and [analysts'] views relating to the importance and usefulness of various financial disclosures: [Also included in 1(b), 1(d), 4, and 10(d)] **[KPMG BANK STUDY, p. A-16]**

- **In performing your analysis, indicate the adjustment(s) if any, you make to an institution's financial statements.**

  78% Reversal of realized security gains or losses
  43 Adjust for unrealized security gains or losses
  95 Remove the effects of non-recurring transactions
  23 Reversal of goodwill amortization and other income statement effects resulting from intangible asset
  73 Estimate future credit losses
  63 Estimate future net interest spread
  8 Other
  [KPMG BANK STUDY, p. A-17]

- **For purposes of analyzing a financial institution, indicate the importance of the following risks.**

  Liquidity risk - the risk associated with an institution's ability to meet all financial commitments

  Interest rate risk - the risk associated with changes in earnings due to changes in interest rates

  Market risk - the risk associated with the variability in returns resulting from fluctuations in the market

  Credit risk - the risk associated with the possibility that a loss may occur because a party to a transaction fails to perform according to the terms of the contract

Regulatory risk - the risk associated with an institution's ability to comply with regulatory requirements

	Very Important	Important	Not Important	Not Applicable
Liquidity risk	35%	50%	13%	2%
Interest rate risk	55	43		2
Market risk	20	55	23	2
Credit risk	95	3		2
Regulatory risk	43	53	3	1
Other	3	0	0	0

[Also included in 10(d)] **[KPMG BANK STUDY, p. A-17]**

How do you evaluate these risks?

Liquidity - detailed analysis of deposit footnote and managements funding strategy.
Interest rate - rate/volume analysis; gap analysis and discussions with management regarding simulation analysis.
Market - macroeconomic analysis.
Credit - visits to local lending area, review of credit exposures by industry, loan type, credit condition, discussion with management and borrowers.
Regulatory - discussion with management.

In context with all other factors. For example, using published financial statements, filings and frequent discussions with management and competing institutions.

Use published financial statements, SEC filings, management discussion and analysis, contacts with management and regulators, and peer group analysis.

Liquidity risk - balance sheet analysis of funding sources and asset liquidity.
Interest rate risk - we do some simple simulations but I believe it's impossible for an outsider to fully understand the rate risk.
Credit risk - use detailed loan portfolio analysis and simulation.

These risks are evaluated through review of SEC reports, call reports and discussions with management.

Ratio analysis and discussions with management.

Liquidity - ability to maintain substantial unpledged assets
Interest rate - stability of margin; elasticity to open market over time; and GAP measurement
Market - should be mitigated by balance sheet diversification

Credit - portfolio composition, concentration, local economy, historic charge-offs, and reserves
Regulatory - margin of safety relative to current requirements.

Liquidity and interest rate - funding mix versus asset mix.
Market - macroeconomic environment.
Credit - Non-performing asset and provision disclosure and microeconomic information.
Regulatory - read the newspapers.

By reading required reports, interviewing management and listening to the street (Main Street or Wall Street).
Liquidity risk isn't important because the Federal Government has assumed this risk via the safety net (FDIC, etc.).

Carefully.

Liquidity - core deposits to loans; core deposits as % of total funding
Interest rate risk - gap analysis, maturity of investment portfolio/loan portfolio
Credit risk - loan concentrations, non-performing asset rating
Regulatory risk - status of examinations (most recent, results, etc.)

From company disclosures and our expectations of future market and economic conditions.

Liquidity risk - examine balance sheet structure - emphasize liabs.
Interest Rate risk - review historical behavior; seek management policy
Market risk - not important
Credit risk - attempt to monitor expenses, economic conditions, past credit experience and management policy
Regulatory risk - monitor developments; participate where possible in evaluation of proposed changes.

Credit and liquidity risks are more quantifiable for ratings agencies, but markets and to a lesser extent interest risks, are subject to more qualitative assessments. Regulatory risks in the US banking sector has grown as regulatory behavior remains negative and increasingly inconsistent.

Peer comparison, judgment, figures provided supplemented by management discussions.

Books have been written on each of these. Some shift in importance depending on the economic and market environment liquidity and interest rate risks may be modest today but could be more important in two years.

Liquidity Risk - simple ratio
Interest Rate Risk - one year gap
Market Risk - relative valuation
Credit Risk - composition of loans, non-performing assets, past history
Regulatory Risk - risk based capital compliance cushion.

[Also included in 10(d)] **[KPMG BANK STUDY, p. A-17, A-18, and A-19]**

Estimates of fair value may vary by institution because of different assumptions, methodologies and the practicability of such disclosure. The following questions relate to the reliability and comparability of fair value estimates: [Also included in 1(b), 1(d), 2(b), and 4)] **[KPMG BANK STUDY, p. A-20]**

- **Indicate the importance of uniform financial statement presentation of fair value information among financial institutions.**

  85% Very important
  3 Important
  8 Not important
  4 No opinion
  [Also included in 4)] **[KPMG BANK STUDY, p. A-22]**

- **Indicate the importance of uniform fair value methodologies and assumptions among financial institutions.**

  90% Very important
  8 Important
  2 Not important
  0 No opinion
  [Also included in 4)] **[KPMG BANK STUDY, p. A-22]**

- **Indicate the importance of the consistency from period to period of fair value methodologies and assumptions used by a financial institution.**

  90% Very important
  8 Important
  2 Not important
  0 No opinion
  [Also included in 4)] **[KPMG BANK STUDY, p. A-22]**

- **Provide any additional comments:**

  [One user commented] to the extent fair value accounting is adopted, consistency and uniformity over time and across institutions would be essential to maintain credibility. [Also included in 4] **[KPMG BANK STUDY, p. A-22]**

  [One user commented] as I noted earlier in this questionnaire, comparability is a legitimate concern. **[KPMG BANK STUDY, p. A-22]**

Each rating analysis [of a company by S&P] begins with an assessment of the company's environment. To determine the degree of operating risk facing a participant in a given business, S&P analyzes the dynamics of that business. The analysis focuses on the strength of

industry prospects, as well as competitive factors affecting that industry. [Also included in 1(b) and 10(d)] **[S&P, p. 15]**

The many factors assessed include industry prospect for growth, stability, or decline, and the pattern of business cycles. It is critical to determine vulnerability to technological change, labor unrest, or regulatory interference. Industries that have long lead times or that required fixed plant of a specialized nature face heightened risk. The implications of increasing competition are obviously crucial. S&P's knowledge of investment plans of the major players in any industry offers a unique vantage point from which to assess competitive prospects. [Also included in 1(b), 10(d), and 13] **[S&P, p. 15]**

While any particular profile category can be the overriding rating consideration, the industry risk assessment goes a long way toward setting the upper limit on the rating to which any participant in the industry can aspire. [Also included in 10(d)] **[S&P], p. 15**

As part of the industry analysis, key rating factors are identified--keys to success and areas of vulnerability. A specific company's rating is affected crucially by its ability to achieve success and avoid pitfalls in its business. [Also included in 1(b), 10(b), 10(d), and 13] **[S&P, p. 16]**

The basis for competition determines which factors are analyzed for a given company. [Also included in 1(b), 10(b), 10(d), and 13] **[S&P, p 16]**

For any particular company, one or more factors can hold special significance, even if that factor is not common to the industry. For example, the fact that a company has only one major production facility should certainly be regarded as an area of vulnerability. Similarly, reliance on one product creates risk, no matter how successful that product. For example, one major pharmaceutical company has reaped a financial bonanza from a single drug. The firm's debt is highly rated, given its exceptional profits and cash flow--but it would be viewed still more favorably if it were not dependent on a single medication, which is subject to competition and patent expiry. [Also included in 1(b), 10(b), 10(d), and 13] **[S&P, p.16]**

When a company participates in more than one business, each segment is analyzed separately. A composite is formed from these building blocks, weighting each element according to its importance to the overall organization. Then the potential benefits of diversification, which may not be apparent from the additive approach, are considered. [Also included in 1(b), 10(b), 10(d), and 13] **[S&P, p. 16]**

Market share analysis is often an important rating consideration. However, large shares are not always synonymous with competitive advantage or industry dominance. For instance, if an industry has a number of large but comparably sized participants, none may have a particular advantage or disadvantage. conversely, if an industry is highly fragmented, even the large firms may lack pricing leadership potential. [Also included in 1(b), 10(b), 10(d), and 13] **[S&P, p. 16]**

Management is assessed for its role in determining operational success, and also for its risk tolerance. The first aspect is incorporated in the competitive position analysis; the second is weighted as a financial policy factor. [Also included in 1(b) and 13] **[S&P, p. 19]**

Essentially, subjective judgments lead to S&P's conclusions regarding each aspect of management evaluation. Opinions are formed during the meetings that regularly take place with senior management. While management's track record may seem to offer an objective basis for evaluation, it often is difficult to determine how results should be attributed to management's skills. S&P must decide to what extent they are the result of good management, devoid of management influence, or achieved despite management. [Also included in 1(b) and 13] **[S&P, p. 19]**

Plans and policies have to be judged for their realism. Management credibility is an important factor. Once earned, credibility can support continuity of a particular rating. When a company is faced with stress or restructuring, S&P often will rely on management to carry out plans for restoring creditworthiness. Otherwise, S&P's view is that stated policies often will not be followed, and the ratings will reflect that skepticism. [Also included in 1(b) and 13] **[S&P, p. 19]**

S&P's evaluation also is sensitive to potential organizational problems. These include situations where:

- there is significant organizational reliance on an individual, especially one who may be close to retirement.
- the finance function and finance considerations do not receive high organizational recognition.
- management transition--to professional and organizational from entrepreneurial or family-bound--has not yet been accomplished.
- a relatively large number of changes occur in a short time.
- the relationship between organizational structure and management strategy is unclear.
- a substantial presence by one or a few shareholders exists, imposing constraints on management prerogatives.

[Also included in 1(b) and 13] **[S&P, p. 19]**

The organizational structure, first and foremost, needs to be understood in the context of the business environment, including past practices and future needs. [Also included in 1(b) and 13] **[S&P, p. 19]**

Having evaluated the issuer's competitive position and operating environment, the analysis proceeds to several financial categories. To reiterate: the company's business-risk profile determines the level of financial risk appropriate for any rating category. Financial risk is portrayed largely through quantitative means, particularly by using financial ratios. [Also included in 1(b)] **[S&P, p. 19]**

Analysis of the audited financials begins by reviewing the accounting quality. This determines whether ratios and statistics derived from financial statements can be used accurately to measure a company's performance and position relative to competition and the larger universe of industrial companies. The rating process is very much one of comparisons, so it is important to have a common frame of reference. [Also included in 1(b)] **[S&P, p. 19]**

Accounting policies to be reviewed include:

- Consolidation basis (FASB now requires consolidation of even nonhomogenous operations. For analytical purposes, it is critical to separate these and evaluate each of business in its own right.)
- Income recognition (for example, successful efforts versus full cost in the oil industry, and percentage of completion versus completed contract in the construction industry)
- Depreciation methods and asset lives
- Inventory pricing methods
- Amortization of intangibles
- Employee benefits.

[Also included in 1(b)] **[S&P, p. 19]**

Importantly, the impact of purchase accounting and varied off balance sheet liabilities is assessed. To the extent possible, analytical adjustments are made to better portray reality. Although it is not always possible to completely recast a company's financial statements, it is useful to have some notion of the extent performance or assets are overstated or understated. At the very least, the choice of accounting alternatives can be characterized as generally conservative or liberal.[Also included in 1(b)] **[S&P, p. 19-20]**

S&P emphasizes the importance of management's philosophies and policies involving financial risk. [Also included in 1(b)] **[S&P, p. 20]**

The analysis of all the financial categories covers both historical and projected performance. Because a rating is an assessment of the likelihood of timely payment of interest and future repayment of principal, the evaluation emphasizes future performance. However, the rating analysis does not attempt to forecast performance precisely or to pinpoint economic cycles. Rather, the forecast analysis considers variability of expected future performance based on a range of economic and competitive scenarios. [Also included in 1(b)] **[S&P, p. 20]**

The profitability category actually encompasses two analytical areas. First, a company's earning power is measured. In the long run, profit potential is a critical determinant of credit protection. Second, earnings are viewed in relation to a company's burden of fixed charges. Otherwise-strong performance can be affected detrimentally by aggressive debt financing, and the opposite also is true. [Also included in 1(b)] **[S&P, p. 20]**

The more significant measures of profitability are:

- Return on capital
- Profit margins
- Earnings on business segment assets.

[Also included in 1(b)] **[S&P, p. 20]**

While the absolute levels of ratios are important, it is equally important to focus on trends and compare these ratios with those of competitors. Since industries follow different cycles and have different earnings characteristics, what may be considered favorable for one business may be relatively poor for another. [Also included in 1(b)] **[S&P, p. 20]**

S&P evaluates several fixed-charge coverage ratios, but the two primary ones are pretax interest coverage and pretax coverage of interest plus total rents. If preferred stock is

outstanding and material, fixed charges are adjusted to include preferred dividends. To reflect more accurately the ongoing earnings available to pay fixed charges, the reported figures typically are adjusted. The effect of LIFO liquidations, foreign exchange gains, and unremitted equity are excluded, as well as those of non recurring or extraordinary gains and losses. Similarly, the focus is coverage of interest payable, so adjustments are made where interest has been capitalized. [Also included in 1(b)] **[S&P, p. 20-21]**

Particularly important is management's plan for achieving earnings growth. S&P evaluates whether existing businesses can provide satisfactory growth, especially in a less inflationary environment, and to what extent acquisition--or divestitures--may be necessary to achieve corporate goals. [Also included in 1(b)] **[S&P, p. 21]**

Ratios employed by S&P to capture the degree of leverage used by a company include:
- Total debt/total debt + equity
- total debt + off balance sheet liabilities/total debt + off balance sheet liabilities + equity
- Total debt/total debt + market value of equity
- Long term debt/long term debt + equity

[S&P, p. 21]

A company's asset mix is a critical determinant of the appropriate leverage for a given level of risk. Assets with stable cash flow or market values justify greater use of debt financing than those with clouded marketability. Adjustments are made for companies with disproportionate amounts of cash, investments, or receivables. [Also included in 1(b)] **[S&P, p. 21]**

Knowing the true values to assign a company's assets is key to the analysis. S&P's analysis highlights materially undervalued or overvalued assets relative to book value so that asset protection can be viewed in an alternate light. S&P considers the profitability of an asset as the basis for determining its economic value. Market values of a company's assets or independent asset appraisals can offer additional insights. However, there are shortcomings in these methods of valuation (just as there are with historical cost accounting) that prevent reliance on any single measure. [Also included in 1(b)] **[S&P, p. 21]**

- Off balance sheet items factored into the leverage analysis include:
- Operating leases
- Pension obligations (. . .)
- Debt of joint ventures and unconsolidated subsidiaries
- Guarantees
- Take-or-pay contracts and obligations under throughput and deficiency agreements
- Receivables that have been factored, transferred or securitized
- Potential legal judgments or lawsuit settlements

[Also included in 1(b)] **[S&P, p. 21]**

S&P uses various methodologies to determine the proper adjustment value for each off balance sheet item. In some cases, the adjustment is straightforward. For example, the amount of guaranteed debt can simply be added to the guarantor's liabilities. Other adjustments are more complex or less precise. [Also included in 1(b)] **[S&P, p. 21]**

Debt of a joint venture is often apportioned to its parents according to their share of ownership. However, if the venture is more critical to one of the partners' operations, it may be appropriate to burden that partner with a disaproportionate amount of the debt. Similarly, the partners' relative ability to service the joint venture debt helps determine the analytical attribution of the debt. Sometimes owners have little incentive to support the venture's debt if it is large enough in relation to their investment. In those cases, an adjustment would be made to write down the owner's investment, rather than adding debt to their balance sheet [Also included in 1(b)] **[S&P, p. 22]**

In the case of contingencies, an estimate can be developed. [Also included in 1(b)] **[S&P, p. 22]**

The sale or securitization of accounts receivable represents a form of off balance sheet financing. If used to supplant other debt, the impact on credit quality is neutral. (There can be some incremental benefit to the extent that the company has expanded access to capital, but there may also be an offset in the higher cost of such financing.) For ratio calculation, S&P would add back the amount of receivables and a like amount of debt. This eliminates the distorting, cosmetic effect of utilizing an off balance sheet technique and allows better comparison with other firms that have not chosen this avenue of financing. Similarly, if a firm uses proceeds from receivables sales to invest in riskier assets--and not to reduce other debt--the adjustment will reveal an increase in financial risk. [Also included in 1(b)] **[S&P, p. 22]**

The debt-equivalent value of operating leases is determined by calculating the present value of minimum operating lease obligations as reported in the annual report's footnotes. The lease amount beyond five years is assumed to mature at a rate approximating the minimum payment due in year five. [Also included in 1(b)] **[S&P, p. 22]**

The variety of lease types may require the analyst to obtain additional information or use estimates to evaluate lease obligations. This is needed whenever lease terms are shorter than the assets' expected economic lives. For example, retailers report only the first period of a lease written with an initial period and several renewal options over a long term. Another limitation develops when a portion of the lease payment is tied to sales, often the case in the retailing industry. [Also included in 1(b)] **[S&P, p. 22]**

As financing techniques become more innovative, ratio analysis becomes more complicated--and probably more tenuous as well. The analyst distinguishes between the different hybrid debt securities based on their features. [Also included in 1(b)] **[S&P, p. 22]**

Convertible securities are considered debt, albeit at a reasonable capital cost, until they actually convert. Many well-intentioned companies project conversion within a short time but fail to accomplish it. Conversion is subject to enough variables beyond management's control that a prediction of when it might occur becomes presumptuous. [Also included in 1(b)] **[S&P, p. 22]**

Debt sold at original issue discount, such as zero coupon debt, is valued net of unamortized discount (the amount of legal liability) for purposes of capital structure analysis. However,

borrowings will increase with time, and the growing amounts are taken into account in cash flow analysis. Since there is no sinking fund provision, the issue matures all at once, creating a very sizable refinancing requirement that could test a company's financial flexibility. The need to refinance a very large amount at one time can become a challenge unless prudent steps are taken to anticipate the need. [Also included in 1(b)] **[S&P, p. 22]**

Any preferred [stock] that the analyst believes will be refinanced eventually with debt should be viewed as a debt equivalent, not equity, all along. [Also included in 1(b)] **[S&P, p. 23]**

There are preferred stock issues that represent merely a debt alternative for companies that are not current taxpayers and, therefore, do not benefit from tax deductibility of interest expense. Auction preferreds, for example, are "perpetual" on the surface. However, the typical issuer is not motivated to keep such preferreds permanently outstanding. Other redeemable preferred stock issues also are likely to be refinanced with debt once an issuer becomes a taxpayer. Preferreds that can be exchanged for debt at the company's option also may be viewed as debt in anticipation of the exchange. [Also included in 1(b)] **[S&P, p. 23]**

Preferreds with sinking funds represent a hybrid, with elements of debt and equity. Sinking fund requirements are comparable to debt maturities, and rarely does a corporation finance the sinking fund payment through cash flow or with newly issued equity, common or preferred. Rather, the sinking fund payment is met through debt issuance, which results in the sinking fund preferred being just the precursor of debt. It would be misleading to view sinking fund preferreds, particularly that portion coming due in the near to intermediate term, as equity, only to have each payment convert to debt on the sinking fund payment date. Accordingly, S&P views at least that portion of the issuer's sinking fund preferreds due within the next five years as debt. A supplementary analysis views the entire issue as debt, since, presumably, it will eventually be debt. [Also included in 1(b)] **[S&P, p. 23]**

Discussions with company management can help determine whether a given preferred stock issue is intended as a permanent feature of the capital structure, as well as circumstances that might lead to replacement or refinancing. The burden of proof is often the issuer's to show that a preferred transaction represents more than pseudoequity. [Also included in 1(b)] **[S&P, p. 23]**

Earnings power may be the best long-term determinant of creditworthiness, but when an interest or principal payment data arrives, earnings are not what matters. The obligation cannot be serviced out of earnings, which is just an accounting concept; payment has to be made with cash. Although there is usually a strong relationship between cash flow and reported earnings, many transactions and accounting entries affect one and not the other. Analysis of cash flow patterns can reveal a level of debt-servicing capability that is either stronger or weaker than might be apparent from earnings. [Also included in 1(b)] **[S&P, p. 23]**

Cash flow analysis is critical in all credit rating decisions. Lately, it has taken on added importance as the debt market has been increasingly populated by speculative-grade issuers. While companies with investment-grade ratings generally have ready access to external cash to cover temporary shortfalls, junk bond issuers lack this degree of flexibility and have fewer

alternatives to internally generated cash for servicing debt. [Also included in 1(b)] **[S&P, p. 23]**

Ratios show the relationship of cash flow to debt and debt service, and also to the firm's business needs. Since there are calls on cash other than repaying debt, it is important to know the extent to which those requirements will allow cash to be used for debt service or, alternatively, lead to greater need for borrowing. [Also included in 1(b)] **[S&P, p. 23]**

Some of the specific ratios considered are:

- Funds from operations/total debt
- Total debt/discretionary cash flow (debt payback period)
- Funds from operations + interest/interest
- Free operating cash flow + interest/interest
- Free operating cash flow + interest/interest + average annual principal repayment obligation (debt service coverage)
- Funds from operations/capital spending requirements
- Capital expenditures/capital maintenance.

[Also included in 1(b)] **[S&P, p. 23]**

Analysis of cash flow in relation to capital requirements begins with an examination of a company's capital needs, including both working and fixed capital. While this analysis is performed for all debt issuers, it is critically important for fixed capital-intensive firms and rapidly growing working capital-intensive firms. [Also included in 1(b)] **[S&P, p. 24]**

The key to determining working capital requirements of a company is, first, to establish a projected growth rate and turnover rates for inventory and receivables. [Also included in 1(b)] **[S&P, p. 24]**

Because S&P sees companies as ongoing enterprises, it expects they will provide funds continually to maintain capital investments as modern, efficient assets. Cash flow adequacy is viewed from the standpoint of a company's ability to finance capital-maintenance requirements internally, as well as its ability to finance capital additions. [Also included in 1(b)] **[S&P, p. 24]**

Another analytical task covered . . . is the evaluation of a company's options under stress. The potential impact of various alternatives to expectations is considered, along with a firm's contingency plans. Access to various capital markets, affiliations with other entities, and ability to sell assets are important factors. [Also included in 1(b)] **[S&P, p. 24]**

Flexibility can be jeopardized when a firm accumulates bank borrowings or commercial paper with the hope of funding out when market conditions improve. Reliance on short-term money or interest-sensitive funds creates obvious risks. An unusually short maturity schedule for long-term debt and limited-life preferred stock also is a negative. [Also included in 1(b)] **[S&P, p. 24]**

A firm's access to various capital markets can become an important factor in financial flexibility. A company's experience with different financial instruments and capital markets

gives management alternatives if conditions in a particular financial market suddenly sour. [Also included in 1(b)] **[S&P, p. 24]**

[A] company's ability to generate cash through asset disposals may enhance its financial flexibility. Potential asset disposals will be considered as providing added flexibility only if S&P believes they can be accomplished under terms acceptable to the company. Management's stated intention to sell certain assets is not enough; awareness of market conditions is also necessary. [Also included in 1(b)] **[S&P, p. 25]**

Pension obligations, environmental liabilities, and serious legal problems are difficult analytical areas. Apart from the question of how to value unfunded pension obligations, there are other implications. A large pension burden can hinder a company's ability to sell assets because potential buyers will be reluctant to assume the liability. This off balance sheet item also has played a pivotal role in discouraging some managements from closing excess, inefficient, and costly manufacturing facilities. Such a closing might require the immediate recognition of future pension obligations and result in a substantial charge to equity, thus impairing the firm's financial flexibility. [Also included in 1(b)] **[S&P, p. 25]**

When there is a major lawsuit against the firm, the analyst may use a range of estimated costs to reflect uncertainty inherent in all litigation. Intangible costs are reflected qualitatively in S&P's assessment of a firm's prospects. Disputes with suppliers or customers can have a long-term effect on a company's competitive position. A well-publicized product failure may cost a company far more in lost sales than payment to any injured individual. A potential liability so large that it seems to threaten a firm's solvency . . . often will limit the company's access to capital, at least temporarily. [Also included in 1(b)] **[S&P, p. 25]**

Discussions about cash flow often suffer from lack of uniform definition of terms. The table illustrates S&P's terminology with respect to specific cash flow concepts. At the top is the item from the funds flow statement usually labeled "funds from operation" or "working capital from operation." This quantity is net income adjusted for depreciation and other noncash debits and credits factored into it. Subtract the net increase in working capital investment to arrive at "operating cash flow." [Also included in 1(b) and 5(c)] **[S&P, p. 25]**

Next, capital expenditures and cash dividends are backed out to arrive at "free operating cash flow" and "discretionary cash flow", respectively. Finally, cost of acquisitions is subtracted from the running total, proceeds from asset disposals added, and other miscellaneous sources and uses of cash netted together. "refinancing cash flow" is the end result of these computations, which represents the extent to which company cash flow from all internal sources has been sufficient to cover all internal needs. [Also included in 1(b) and 5(c)] **[S&P, p. 25]**

The bottom part of the table reconciles prefinancing cash flow to various categories of external financing and changes in the company's own cash balance. In the example, XYZ Inc. experienced a $35.7 million cash shortfall in year one, which had to be met with a combination of additional borrowings and a drawdown of its own cash. [Also included in 1(b) and 5(c)] **[S&P, p. 25]**

Cash flow summary: XYZ Corp.

($Mil.)	Year One	Year Two
Working capital from oper. (FFO)	18.58	22.34
Dec. (inc.) in noncash current assets	(33.12)	1.05
Inc. (dec.) in nondebt current liabilities	15.07	(12.61)
Operating cash flow	0.52	10.78
(Capital expenditures)	(11.06)	(9.74)
Free Oper. cash flow	(10.53)	1.04
(Cash dividends)	(4.45)	(5.14)
Discretionary cash flow	(14.98)	(4.09)
(Acquisitions)	21.00	0.00
Asset disposals	0.73	0.23
Net other sources (uses) of cash	(0.44)	(0.09)
Prefinancing cash flow	(35.70)	(3.95)
Inc. (dec.) in short-term debt	23.00	0.00
Inc. (dec.) in long-term debt	6.12	13.02
Net sale (repurchase) of equity	0.32	(7.07)
Dec. (inc.) in cash and securities	6.25	(2.00)

[Also included in 1(b) and 5(c)] **[S&P, p. 25]**

The utility rating methodology encompasses two basic components: qualitative business analysis and financial analysis. Qualitative aspects of a utility's operations are likely to shape the nature of long-term financial results. Therefore, analysis of the industry in which a utility operates, a judgment as to its operating position within that industry, review of regulation, and evaluation of management provide the context for assessing a firm's financial condition. [Also included in 1(b)] **[S&P, p. 26]**

Financial categories are evaluated using quantified measures of relative financial performance, while the business categories require subjective assessment, against the backdrop of economic, social and political trends affecting utility operations. The view is prospective. S&P is concerned with events and results that will shape bondholder protection today and tomorrow rather than those that determined it yesterday. However, historical evaluation is vital in the analytical process, as a tool for identifying strengths and weaknesses, and measuring financial prospects. [Also included in 1(b)] **[S&P, p. 26]**

Assessing service territory begins with the economic and demographic evaluation of the area in which the utility has its franchise. Strength of long term demand for the product is examined from a macro-economic perspective. The staying power of demand is rooted in the service territory economy. It is evaluated by reviewing historical and prospective sales and revenue patterns by customer class and by industry dependence. For example, heavy industrial concentration is viewed cautiously since the utility may have significant exposure to cyclical volatility. A large residential component, on the other hand, produces a more stable and predictable revenue steam. [Also included in 1(b)] **[S&P, p. 26]**

Assessment of present and prospective fuel and power supply is critical to every electric utility analysis, and gauging the long-term natural gas supply position is an important gas pipeline and distribution company consideration. There is no similar analytical category for telephone utilities. [Also included in 1(b)] **[S&P, p. 27]**

[For measures of operating efficiency,] S&P attempts to evaluate the nature of operations from the perspective of cost and quality of service. S&P analysts seek to identify those areas which require management attention in terms of time or money and which, if unresolved, may lead to political, regulatory, or competitive problems. Cost of service is compared against the costs of other utilities in the same regulatory jurisdiction and operating situation. For electric utilities, reliability is also important. The status of utility plant investment is reviewed, with regard to generating plant availability and utilization, and also for compliance with existing and contemplated environmental and other regulatory standards. The record of plant outages, equivalent availability, and capacity factors are examined. [Also included in 1(b)] **[S&P, p. 28]**

[For utilities,] regulation plays a key role in shaping overall financial performance. The utility group meets frequently with commission and staff members, both at S&P offices and at commission headquarters, demonstrating the importance S&P places on the regulatory arena for credit quality evaluation. Input from these meetings and from review of rate orders and their impact weigh heavily in S&P's analysis. [Also included in 1(b)] **[S&P, p. 28]**

S&P follows the progress of major projects to assess if they are well-managed or troubled. The size or magnitude of an electric utility's construction program or a particular asset relative to net worth or net plant in service is an important consideration. Investment in a single asset representing a significant percentage of total investment suggests high risk. Where substantial asset concentration exists, the financial profile of a company may experience wide swings depending on the asset's performance. [Also included in 1(b)] **[S&P, p. 28]**

[For a utility], where non-utility business exposure exists, S&P assesses the degree of business risk inherent in non-utility operations and measures the non-utility investment (both present and prospective) to determine the extent to which utility financial criteria should be adjusted to reflect these factors. In instances where a utility company is affiliated with non-utility businesses through a holding company, factors which contribute to common or separate credit risk are analyzed to determine the impact on the utility's credit quality. [Also included in 1(b)] **[S&P, p. 29]**

Evaluating management [of a utility] is of paramount importance to the analytical process since management decisions affect all areas of a company's operations. While regulation, the economy, and other outside factors can influence results, it is ultimately the quality of management that determines the success of a company. [Also included in 1(b)] **[S&P, p. 29]**

S&P assesses management's demonstrated commitment to a given level of credit quality, as reflected in their business strategies and financial track record. S&P seeks evidence of that commitment through well-reasoned planning for the future, including contingency options to demonstrate flexibility. Management quality is also indicated by thoughtful balancing of

public and private priorities, a record of credibility, and effective communication with the public, regulatory bodies, and the financial community. [Also included in 1(b)] **[S&P, p. 29]**

In the earnings protection category, S&P analysts focus on pretax cash income coverage of all interest charges. For this calculation, allowance for funds used during construction (AFUDC) is removed from income and interest expense. To identify total interest expense, S&P disaggregates from operating expenses the interest component of various off balance sheet obligations, like leases and some purchase power contracts, and includes them in interest expense. [Also included in 1(b)] **[S&P, p. 29]**

While considerable emphasis in assessing credit protection is placed on coverage ratios, this parameter alone does not provide the entire earnings protection picture. Also important are a company's earned return on both equity and capital, measures that highlight a firm's earnings performance. Consideration is given to the interaction of embedded costs, financial leverage, and pretax return on capital. [Also included in 1(b)] **[S&P, p. 29]**

Since utilities are so capital intensive, S&P closely examines a firm's ability to tap capital markets on an ongoing basis. External funding capability complements internal cash flow. Financing flexibility incorporates a utility's financing needs, plans, and alternatives, as well as its flexibility to accomplish its financing program under stress without damaging creditworthiness. Debt capacity reflects all the earlier elements: earnings protection, debt leverage and cash flow adequacy. Market access at reasonable rates is restricted if a reasonable capital structure is not maintained and the company's financial prospects dim. [Also included in 1(b)] **[S&P, p. 30]**

S&P assesses a company's capacity and willingness to issue common equity given various factors, including the market-to-book ratio, dividend policy, and any regulatory restrictions regarding the composition of the capital structure. S&P also reviews indenture restrictions and the likely impact of additional debt on covenant tests. In essence, the analytical effort is geared to determining the number of financing alternatives which can be employed to meet ongoing cash requirements. [Also included in 1(b)] **[S&P, p. 30]**

Assessment of corporate credit quality on an international basis follows the same rating methodology as that employed in analysis of U.S. corporates: industry risk and a company's competitive position are evaluated in conjunction with the firm's financial profile and policies. This fundamental analysis is complemented with an appreciation of relevant industry or financial characteristics of a specific country or region. [Also included in 1(b)] **[S&P, p. 31]**

In the spectrum of debt-like equivalents, pension liabilities fall somewhere between operating leases and certain types of contingent liabilities. Unfunded pension liabilities are not viewed in the same light as straight debt, since the amount to be paid in specific future years can be subject to volatile change. Nor does S&P attempt to precisely quantify a pension obligation using any single method: S&P views the obligation from a few perspectives that in combination capture a firm's exposure. [Also included in 1(b)] **[S&P, p. 43]**

S&P's pension analysis

Step 1: Plan asset rate of return versus discount rate. Plan asset rate of return versus wage growth rate.
Step 2: Plan assets as a percentage of projected benefit obligation
Step 3 Adjust balance sheet for plan assets less projected benefit obligation
Step 4: Recalculate funds from operations as a percentage of total debt
Step 5: Discount ERISA's mandatory payment stream for unfunded obligations
Step 6: Recalculate funds from operations as a percentage of total debt
[Also included in 1(b)] **[S&P, p. 43]**

Use a combination of steps 2, 4, and 6 to assess impact on pension obligations on financial risk profile. [Also included in 1(b)] **[S&P, p. 43]**

The analytical process starts with review of the pension footnote and follows several steps to distinguish underfunded plans from adequate or overfunded ones. Pension reporting improvements under Financial Accounting Standards Board's (FASB) Statement 87 have facilitated S&P's method of factoring pension obligations into rating analysis. However, S&P also emphasizes a plan's funding obligations, apart from determining the size of the liability. These funding obligations are determined by Employee Retirement Income Security Act (ERISA) guidelines, which can use actuarial assumptions and cost methods quite different from those under FASB 87 to determine pension expense and liabilities. In fact, if unfunded pension obligations are a material concern, the cash flow impact of funding requirements plays a bigger role in credit evaluation than the balance sheet information. [Also included in 1(b)] **[S&P, p. 43]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

> [Some]. . . analysts. . . have a short-term focus. They are preoccupied with predicting a company's financial performance for the next 18-24 months. Using those predictions of financial performance, they then form judgments about the company's future stock price based on multiples and ratios that they believe the market will apply to those predicted amounts. Those multiples and ratios often include (1) price to earnings, (2) price to book equity, (3) price to cash flow or free cash flow, (4) dividend yield, (5) ratio of book earnings to book equity, (6) ratio of book earnings to book assets, (7) debt to equity ratios, and others. Obviously, the analysts' predictions of future stock prices provides the basis for their buy, hold or sell recommendations. [Also included in 1(a) and 1(b)] **[GOLDMAN, p. ii]**
>
> [Some]. . . analysts. . . follow the anticipation approach. As discussed in the Subcommittee's paper "Methods of Portfolio Management and Identifying Stocks for a Portfolio", investors following the anticipation approach believe that stock prices are closely correlated to reported earnings or the rate of growth in reported earnings. Thus, those investors focus on predicting book earnings. However, the short-term focus of the anticipation approach distinguishes it from the fundamental approach, which has a longer-term perspective. [Also included in 1(a) and 1(b)] **[GOLDMAN, p. ii]**
>
> To better predict a company's short-term financial performance, the analysts focus on the industry's and company's detailed operations. For example, they desire to understand the nature of the specific products produced and services rendered, they try to predict the demand in units for those products and services, and they seek to understand the detailed costs for a specific company to provide those products and services. Each analyst stressed the importance of industry experience and a detailed understanding of the company's operations. The analysts get that understanding from many diverse sources, including frequent contact with management and periodic field trips to companies. [Also included in 1(a) and 1(b)] **[GOLDMAN, p. ii]**
>
> [One analyst] could not see how fair market value accounting could be implemented for real estate entities. The key issue for real estate firms is the tremendous variance in accounting policies towards expensing items versus capitalizing items. He said that earnings per share is a useless number and that cash flow per share is paramount. He defines recurring net income or net funds from operations as net rents minus G&A minus interest. He feels a meaningful ratio is this number (funds from operations) divided by historical costs of all properties. [Also included in 1(b), 4, and 5(a)] **GOLDMAN, p 1]**

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One of the key dimensions to setting standards for financial reporting always has been to determine just what ought to be important purposes of the reports themselves. Two functions that have been under considerable discussion for some time are measuring and analyzing the performance of a company on the one hand, and a comparison of the company with other companies on the other.

In this study, the extent to which current standards enhance and help the process of carrying out both functions was measured.

Table 1.6

HOW MUCH RULES HELP ANALYSIS OF COMPANY PERFORMANCE AND COMPARABILITY

Q.2A—How much do current rules for financial reporting help the process of . . . (READ EACH ITEM). . . . A great deal, some but not a lot, not much, or do the rules set back that process?

		Large Public Companies		Small Public Companies	Private Companies			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	C.E.O.	C.E.O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Measuring and analyzing the performance of a company														
A great deal	44	47	38	30	36	49	54	51	67	33	53	42	45	41
Some but not a lot	47	42	54	58	50	41	44	42	33	53	40	48	42	53
Not much	6	8	6	9	14	5	2	4	–	7	7	3	8	6
Set back process	2	1	1	3	–	5	–	–	–	–	–	3	3	–
Not sure	1	–	–	–	–	–	–	2	–	7	–	3	3	–
No answer	*	1	–	–	–	–	–	–	–	–	–	–	–	–
Comparing it with other companies														
A great deal	45	44	42	33	36	56	52	44	67	27	40	45	47	41
Some but not a lot	44	50	49	58	46	32	41	38	20	53	40	45	34	41
Not much	9	6	9	9	18	7	5	11	7	13	13	3	11	18
Set back process	1	–	–	–	–	2	–	–	–	–	–	3	3	–
Not sure	1	–	–	–	–	–	2	2	–	7	–	3	3	–
No answer	1	–	–	–	–	2	–	4	7	–	7	–	3	–

*Less than .5%.

By 91-8%, a big majority is convinced that the standards for financial reporting help the process of measuring and analyzing the performance of the company and a comparable 89-9% feel the same about the standards helping the process of comparing that company to others.

Observation: *Clearly, the current standards for financial reporting are widely believed to enhance both the function of measuring and analyzing the performance of companies, as well as the function of comparing companies with each other.*

[HARRIS]

1(d). Other

PROFESSIONAL INVESTOR[S'] VIEWS OF VARIOUS TYPES OF INFORMATION]

- **For [the statement below], would you say that you agree or disagree with it?**
  I mainly buy stocks of companies that I think may be taken over, so annual reports don't matter to me.

Results in percentages

	TOTAL
AGREE	5.3
DISAGREE	88.7
DON'T KNOW/NO ANSWER	6.1
TOTAL	100.1

[HILL KNOWLTON, TABLE 3]

- **For [the statement below], would you say that you agree or disagree with it?**
  Annual reports give me a feeling for the "personality" of the company and the management.

Results in percentages

	TOTAL
AGREE	49.4
DISAGREE	43.3
DON'T KNOW/NO ANSWER	7.3
TOTAL	100.0

[HILL KNOWLTON, TABLE 6]

- **For [the statement below], would you say that you agree or disagree with it?**
  Annual reports use too much technical and industry jargon.

Results in percentages

	TOTAL
AGREE	34.4
DISAGREE	59.5

DON'T KNOW/NO ANSWER **6.1**

TOTAL **100.0**
[HILL KNOWLTON, TABLE 9]

- **Do you agree or disagree with the following statements: All too often, annual reports fail to --**

	Percentage Agreeing with Statement
A. Display business segment numbers prominently and clearly.	76
B. Candidly discuss bad news, problems, and what management is doing to solve them.	92
C. Present information that reveals the underlying values of the company	58
D. Present information on company's competitive situation in its various businesses.	92
E. Clearly discuss the outlook for the current year.	62
F. Clearly present management's goals and strategy.	56

[HILL KNOWLTON, p. 14]

A basic information set reported, in summary form [in] analysts [reports] includes EPS, the PE ratio, dividends per share, dividend yield, book value per share, cash flow per share, and return on equity. Analysts report many more items on a per share basis than are currently permitted by GAAP. **[PREVITS, p. 12]**

[Sell-side] analysts may not believe that investors have lengthy horizons in assessing company performance. One analyst, for instance, stated: "We continue to rate these shares as neutral,. . . in the belief that investors are not yet ready to discount earnings growth 24 months in the future." [Also included in 1(c)] **[PREVITS, p. 12]**

There is more analyst coverage of larger companies than of smaller companies as indicated in the fact that no reports are found for many of the "Small cap" companies. . . . **[PREVITS, p. 12]**

A possibly more significant policy concern demonstrated . . . is the lack of sell-side reports for the bulk of publicly traded companies and/or "Small cap" companies which comprise an important part of capital market information demand. Investors or employees or the public

who have an interest in such firms are left to their own resources and to general purpose statements to ascertain the information needed. **[PREVITS, p. 21]**

[A]ttention [is directed to] the need for a better understanding of buy-side analysts' behavior. If the major sell-side analysts, equity and debt, can be generally characterized as income/performance and asset/leverage driven in their information requirements, how does this compare with the information need factors which drive buy-side analysts? **[PREVITS, p. 21]**

[Context] The final two sections of the AIMR report, *Financial Reporting in the 1990's and Beyond*, are reproduced in this category of the database to show them as a whole. These excerpts from the "Executive Summary" of the report serve as an introduction [summaries of the seven positions emphasized also are included in the other categories identified in the brackets following each]:

Many recommendations are made throughout the report in the context of individual topic discussions. Those singled out for special emphasis at the end of the report are:

1. Strive for world-wide acceptable GAAP, including disclosure standards. [18(a)-International harmonization of standards]
2. Set financial information in its business context. [1(b)-Types of information that investors and creditors use and the relative usefulness of that information]
3. Continue to deliberate the role of current values in financial reports. [4-Value information]
4. Recognize all executory contracts. [8(c)-Accounting for leases and other "executory" contracts]
5. Develop standards for reporting comprehensive income. [5(a)-Income statement, including core earnings and comprehensive income]
6. Provide frequent and detailed financial reports. [11(a)-Frequency of interim reporting]
7. Consider cost/benefit analysis from a user viewpoint. [18(c)-Resistance to change]

<u>CONCLUSIONS</u>
Throughout the report we make many other recommendations and establish positions on a variety of issues. Those mattes are set forth for two purposes. First, they announce to the rest of the world our thoughts on issues of mutual importance to investment professionals and to other constituents in the world of financial reporting. Second, they provide an opportunity for AIMR members themselves to form their individual thoughts about the implications of financial reporting and its potential effect on their work in the 1990's and beyond. **[AIMR/FAPC92]**

<u>SUMMARY OF IMPORTANT POSITIONS AND GUIDE TO FUTURE ACTIONS</u>
Much of this report relates to the present state of the art and implications for future developments in financial reporting. Rightfully, so do most of the positions stated in this section. Before presenting them, however, we must note that they all build on positions taken by AIMR in the past. For many years, the AIMR's Corporate Information Committee (CIC), SEC Liaison Committee (SECLC), and Financial Accounting Policy Committee (FAPC) have

spoken often and forthrightly in presenting our views and those of our predecessor association, the Financial Analysts Federation. [Also included in 18(d)] **[AIMR/FAPC92, p. 59]**

The Financial Accounting Policy Committee "maintains contact with both private and public sector accounting groups that establish accounting standards to assure the needs of investors are communicated and included as standards are promulgated." Its primary activity is to react to initiatives from those bodies. The extent of that activity can be noted from Appendix A, a list of the letters of comment produced and sent by the FAPC over a five year period ended April 1, 1992. In addition to its comment letters, the FAPC issues broad position papers on financial reporting and accounting matters. It also has sponsored research on accounting matters, the most recent being quarterly segment reporting. It was commissioned by AIMR to draft this report. [Also included in 18(d)] **[AIMR/FAPC92, p. 60]**

The SEC Liaison Committee is the subcommittee of the Financial Accounting Policy Committee that takes responsibility for AIMR relations with the Securities and Exchange Commission. Appendix B contains a list of its communications with the SEC over the period February 2, 1989 through April 10, 1991. The major work of the Corporate Information Committee is to evaluate the quality of financial reporting and to designate awards to firms that excel in meeting their reporting obligations. Each year, the committee publishes a lengthy report of its findings together with a description of its activities and criteria for selection. Copies of that report are available from AIMR.[26] [Also included in 18(d)] **[AIMR/FAPC92, p. 60]**

We expect the positions set forth below to build on the precedents of the past. That does not prevent them from breaking new ground, but they do not introduce significant inconsistencies with previous AIMR positions. To the extent that they do establish new stances those are largely the result of the changing world that we describe earlier in this report. **[AIMR/FAPC92, p. 60]**

Strive for a World-Wide Acceptable GAAP, Including Disclosure Standards
This report discusses at some length the rapid pace of financial market globalization. One of the main impediments to the efficient movement of capital to the places it is best employed is a lack of information that is comparable in either quantity or quality. We support enthusiastically the efforts of the IASC, IOSCO and others to remove or at least reduce that hindrance. [Also included in 18(a)] **[AIMR/FAPC92, p. 60]**

Our enthusiasm is expressed with an unequivocal caution. We will not consent to a lowering of the standards of disclosure that we currently possess. Investment professionals have been integral constituents in establishing the disclosure system currently in effect. Our criticisms of it notwithstanding, there is none better in the world. Some persons in authority have suggested that it is more important for the United States to conform to a global set of disclosure standards than it is to maintain the level of disclosure that now prevails in the United States.

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[26] The most recent report is for 1990-1991. It is free to AIMR members upon request and may be purchased by others for $50.00. It may be ordered telephoning the AIMR order line at 804-980-3647 or by writing to the Association for Investment Management and Research, 5 Boar's Head Lane, Charlottesville, VA 22903.

We disagree. Our reasons are discussed in detail elsewhere in this report. [Also included in 18(a)] **[AIMR/FAPC92, p. 60]**

Set Financial Information in Its Business Context

In order for financial analysts to make sound judgements and draw rational conclusions, they must judge the performance of individual business enterprises. Performance appraisal is largely a matter of evaluating how well the management of an enterprise has achieved its goals. Businesses are for the most part operated according to plans, either explicit or implicit. Investment professionals aspire to allocate capital to those plans that seem most likely to succeed. In order to do so, they need information of two types. [Also included in 1(b)] **[AIMR/FAPC92, p. 61]**

First, management should explicitly reveal its strategies, plans and expectations. Much of this must come in the form of narrative descriptive material. Dollar amounts of budgeted and other anticipated amounts are useful for expressing plans in more concrete terms. Goals for growth rates in revenues, market share and the like should be stated. Analysts need anticipated amounts of key ratios, such as the return on total invested capital or on equity, the ratio of debt to equity and so forth. Factors that are expected to affect those ratios should be divulged, eg. major financing or capital spending plans. [Also included in 1(b) and 12] **[AIMR/FAPC92, p. 61]**

Second, results need to be reported in a manner that is consistent with the organization and management of the firm. Different entities, even within the same industry, may organize their operations in totally dissimilar ways. Financial analysts need information in formats that allow them to compare those firms both against each other and against their own business plans. The task of devising accounting and disclosure standards to mandate dissemination of information in the fashion we advocate is perhaps not totally surmountable. Thus we look to business enterprises themselves to act with goodwill and in their own interests to explain themselves and their operations in "user friendly" ways even when it is not strictly required. [Also included in 1(b)] **[AIMR/FAPC92, p. 61]**

The Role of Current Values in Financial Reports

A great controversy has arisen recently over "mark-to-market" accounting. Feelings are strong both in favor of it and against it with a spectrum of opinion in between. Financial analysts also have diverse views, even though they are not as extreme as others may be. No financial analyst is opposed to the disclosure of current values, in fact most would welcome it. On the other hand, no analyst is at this time prepared to abandon totally the historic-cost-based but eclectic system of valuation used in accounting today. In fact, most financial analysts are going to require much persuasion before they will be willing to accept expansion of the role of current value in financial statements themselves. [Also included in 4] **[AIMR/FAPC92, p. 61]**

Much of the unwillingness of financial analysts to accept immediately a greater use of market values in financial statements stems from a perceived need for utmost reliability in the numbers provided to them. They feel that even though historic costs are subject to certain manipulation, the situation could be worse with respect to numbers that are not verifiable by reference to a transaction in which the enterprise participated. Some analysts are concerned

also about partial measures. They feel, for example, that marking the securities portfolio and (perhaps) other assets of a bank to market is misleading if that institution's liabilities are not revalued also. Their concern is the one expressed in the preceding section, that the financial report on the business will not reflect the manner in which it is managed. [Also included in 4] **[AIMR/FAPC92, p. 61-62]**

The process of learning to understand and use new and unfamiliar financial information is longer and more arduous than anyone might expect. In FAS 33, we were provided with information that, although imprecise, was a godsend to those financial analysts who understood it and were able to use it in their work. Unfortunately, the FASB's five-year experiment came to an end before more than a modicum of financial analysts were able to take the necessary time from the press of their day-to-day duties to study and grasp the significance of inflation-adjusted data. That experience also was undermined by the incessant claims of individual business enterprises that the disclosures required by FAS 33 were worthless, and by the rapid decline in the rate of inflation during that five-year period. [Also included in 4] **[AIMR/FAPC92, p. 62]**

Our position is that we would like current value reporting to be given a chance. We need to be able to assess the extent to which volatility really exists even though the financial statements themselves may, as a political matter, need to be shielded from it. As long as current values are not seen, financial analysts cannot use them. However, the vehicle of disclosure should be used so as to offer financial analysts the opportunity to use current values. They should not be coerced into it by a sudden and unilateral removal from financial statements of the historic costs and other amounts which are familiar and useful to so many financial analysts. [Also included in 4] **[AIMR/FAPC92, p. 62]**

<u>Recognize All Executory Contracts</u>
We all have struggled to understand the immense body of detailed rules that govern accounting for leases. Sometimes it seems as if the only persons having sufficient motivation to study their particulars are those who need to write lease contracts that produce desired outcomes. We know that the criteria for distinguishing between capital lease and operating lease set forth in FAS 13 and its supplements are arbitrary and their application often is willfully capricious. Sometimes it seems as if the opportunities to manipulate the rules are in direct proportion to their copiousness. [Also included in 8(c)] **[AIMR/FAPC92, p. 62]**

We believe the rules could be simplified. First, we would drop the current dichotomy between accounting standards for leases and those for other executory contracts. We would have them treated in the same way. Second, we believe that financial reporting would be improved considerably if all executory contracts of more than one year duration were to be capitalized. That would result in the recognition of all receivables and payables at the present value of future legally enforceable commitments to exchange cash in the future. Our reasoning is set forth earlier in this report. [Also included in 8(c)] **[AIMR/FAPC92, p. 62]**

<u>Develop Standards for Reporting Comprehensive Income</u>
Financial analysts continue to place heavy emphasis in their work on the income statement. It produces the numerator of earnings per share calculations and the denominator of the price to earnings ratio, two stalwart numbers in the investment world. Analysts also recognize that

earnings comprises a multitude of components of varying quality: some are repetitive, others are not; some are operating items, others are not; some are the product of accounting rituals, others are not; some represent economic events of the current period, others do not. Much effort is required of analysts to locate and evaluate all of the income statement items that can have a bearing on their forecasts of the future and the valuation of the firm. [Also included in 5(a)] **[AIMR/FAPC92, p. 63]**

Much of this report is devoted to marshalling evidence and arguments to support our position that the FASB needs to move comprehensive income from concept to application. We believe the arguments are strong and hope to see progress in this matter in the not-too-distant future. [Also included in 5(a)] **[AIMR/FAPC92, p. 63]**

Provide Frequent and Detailed Financial Reports

Interim financial reporting requirements in this country have been the subject of much unjust criticism. They have been blamed for everything from "short termism" to a degradation in U.S. competitiveness. Not only are those charges without merit, they also fail to credit interim reporting for its vital role in keeping investors informed, diminishing opportunities for trading on privileged information, and maintaining peak efficiency of the financial markets. We believe we present in this report and elsewhere[27] valid reasons to continue mandated quarterly financial reporting. [Also included in 11(a) and 3(d)] **[AIMR/FAPC92, p. 63]**

One of the primary deficiencies in contemporary financial reports is the minuscule amount of disaggregated data. In annual reports, that which is provided usually is skimpy and many firms have interpreted the provisions of FAS 14 so as to report fewer segments than an analyst might expect, and sometimes segments are defined by the firm in peculiar ways. Not only are we in urgent need of new definitions and disclosure requirements to emanate from the newly-inaugurated FASB project on disaggregation, we also need segment reporting extended to interim reports. Analysis of a complex enterprise with diverse operations is futile in the absence of significant quantities of disaggregated financial data. [Also included in 11(a) and 3(d)] **[AIMR/FAPC92, p. 63]**

Cost/Benefit Analysis from a User Viewpoint

The benefits of producing financial statement information should exceed the cost of producing it. That is an axiom often cited by financial statement preparers in opposition to a proposed change in financial reporting practice. We not only do not object to that precept, we support it strongly. Our objection is to how it is portrayed by others. [Also included in 18(c)] **[AIMR/FAPC92, p. 63-64]**

We believe it is the owners of business firms who both reap the benefits and bear the costs of improvements in accounting and disclosure standards. The financial managers of business firms act simply as agents of the owners. In that regard, it is the current and potential shareholders and their financial advisors who should best be able to advise standard-setting and regulatory bodies as to the proper balance of costs and benefits associated with their proposals. [Also included in 18(c)] **[AIMR/FAPC92, p. 64]**

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[27] Korn, *op. cit.* [The Need for Quarterly Financial Reports from Publicly Owned Companies: A response to the Competitiveness Debate (AIMR, 1992).]

This position is corollary to the overall stance of AIMR, all other investors, and other users of financial statements. Financial statements are prepared and disseminated to provide the information that free financial markets need to operate. Users are the customers to be served. They also pay for the benefits they receive, albeit indirectly. Sometimes financial statement users are accused of being "free riders," receiving all of the benefits of financial reporting and paying none of the costs. The illogic and untruth of that statement must be apparent to anyone who makes the effort to analyze it thoughtfully. If not, then this report has failed to meet one of its goals. [Also included in 18(c)] **[AIMR/FAPC92, p. 64]**

CONCLUSIONS

This report is the latest in a series of occasional position papers prepared by the Financial Accounting Policy Committee of AIMR. It is the first of those to be endorsed by the entire AIMR membership. It sets forth the position of investment advisors and financial analysts on the universe of financial reporting as it affects analysis today and into the next century. It explains in much detail the function of financial analysis, its sources and uses of information in general and financial reports in particular. It speaks to trends that are expected to change practices both in analysis and accounting over the next decade or more. It addresses many issues of current importance and controversy. Some of its overall conclusions are mentioned below. **[AIMR/FAPC92, p. 64]**

The interaction of financial analysis and financial reporting is one that increases enormously the level of efficiency in the capital markets. One of the major tenets of a free enterprise economic system is that information is disseminated completely and fairly to all market participants. That is of course an ideal which in reality must be thought of as an unattainable standard against which to measure actual achievement. Placed in that context, our positions in this report are eminently supportable despite the fact that in many cases they call for substantial expansion of the quantity and quality of financial information now being reported. **[AIMR/FAPC92, p. 64]**

The role of the attest function receives somewhat less attention herein. We have observed much turmoil in the world of public accounting and are hard put to prognosticate its future course. We continue to consider attestation necessary to the credibility of financial reports, but have suggestions as to how it can be made more effective and efficient. We suggest a longer view of the process at present with the consequence that full annual audits of some enterprises may not be necessary. We suggest a shift of emphasis from transaction-based to systems-based auditing. The role of the external auditor might subtly shift from attestation to "reliability enhancement." **[AIMR/FAPC92, p. 64-65]**

A major portent for changing the future of financial reporting is the fact that capital markets now are global. That has led to both conflict and promise. The downside is the view of certain prominent market officials that the currently high level of accounting and disclosure standards that we enjoy in the United States be relaxed so that more foreign securities can be traded in U.S. markets. AIMR will continue to combat that movement with all of its resources. The good news is that there are accelerating attempts to internationalize accounting standards by the International Accounting Standards Committee together with an

increased interest on the part of national standards-setting bodies to support that process. **[AIMR/FAPC92, p. 65]**

Finally, we note the reasons why financial analysts and other financial statement users sometimes are viewed as outsiders or even nonparticipants in the standard-setting process. Financial reporting is not the focus or total raison d'etre of their employment. Unlike accounting professionals, financial analysts participate as volunteers and oftentimes to the detriment rather than enhancement of their professional development and standing. Furthermore and more importantly, financial analysts have infrequent opportunities to sit in the seat(s) of decision-making power. Their comments are sought, but often either not heard or not heeded. The view of them as outsiders stems less from their unwillingness or inability to participate and more from their exclusion from the process. The FASB has had seven members throughout the nineteen years of its existence, a total of 133 man-years. Five of those years (3.76%) were contributed by a financial analyst. The time has come to make amends. Financial statement users need much more of a direct voice in the process than they have been given in the past. **[AIMR/FAPC92, p. 65]**

Throughout the report we make many other recommendations and establish positions on a variety of issues. Those matters are set forth for two purposes. First, they announce to the rest of the world our thoughts on issues of mutual importance to investment professionals and to other constituents in the world of financial reporting. Second, they provide an opportunity for AIMR members themselves to form their individual thoughts about the implications of financial reporting and its potential effect on their work in the 1990's and beyond. **[AIMR/FAPC92, p. 65]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of auditor involvement. During the discussion, some investors addressed the distinction between the role of the accountant and the analyst.

Committee/Staff/Observer
Where does financial reporting end and financial analysis begin? [Also included in 17(c)] **[TI 3/17, p. 16]**

Participant I-16
Financial analysis is about making forecasts on future trends and performance of a business and then putting a value on the securities relating to that business. The financial analyst starts with the financial statements, which are very important. We're not suggesting that the auditor do financial analysis work; I don't presume that the auditor should make a statement on the future trends of a business but rather statements on the role of estimates in the financial numbers that purport to represent past transactions. Secondly, about the adequacy of control systems, I'm less convinced that it could be done; I'm not sure it is essential because that's something that a financial analyst should be able to do. It might be more important to the lay shareholder as opposed to the professional financial analyst. [Also included in 9 and 17(c)] **[TI 3/17, p. 16]**

Participant I-12
Coming back to the question about where the accounting profession ends and the analytical profession begins because I think this issue has come up more than once in this discussion group. My view is that the accounting profession in general records the business and it makes it available to the owners of the business to see what has happened. It's a financial analyst's job to project into the future and say what will happen. My concern is the importance of transparency of the financial statements, to see and understand where all those numbers come from. To me, disclosure is a vitally important issue to our profession. **[TI 3/17, p. 16-17]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to discussing the types of information creditors use to achieve their objectives. During the discussion, comments were made on information to be disclosed by public versus private companies.

Participant C-5
We typically are legal entity reporting, and we do demand that of our borrowers. We look for legal entity statements at the borrowing/operating company level. We make that demand despite the fact that it's not required for SEC reporting. We get the kind of information we need. I would put that lower on the scale as far as requirements. As I said, the recurring nature and the projecting core earnings is really the driver for us. But if it is out there, the idea of imposing it on the small borrower or the private sector borrowing is not something that I see as necessary. [Also included in 3(e)] **[TC 12/8, p. 36]**

Participant C-1
That's the difference between publicly disclosed information and non-public inside information. And I think that's one of the problems; you have the ability to get non-public inside information, and we don't have that ability. And we don't want it. [Also included in 3(e)] **[TC 12/8, p. 36]**

Committee/Staff/Observer
Why don't you want it? [Also included in 3(e)] **[TC 12/8, p. 36]**

Participant C-1
The issue that we have is the ability to be active in the markets in the trade. And once we receive non-public inside information, we're frozen. And it's a very fine line that we have to walk as analysts or portfolio managers between non-public inside information and public information. And legal entity borrowing, that's just something we would never see. [Also included in 3(e)] **[TC 12/8, p. 36-37]**

Committee/Staff/Observer
You were drawing a line for us earlier about the insider line where you say you don't want to cross it, because obviously then it hampers your ability to do anything with respect to that company. Does this need to know more about litigation get close to that line? [Also included in 1(b)] **[TC 12/8, p. 54]**

Participant C-1
It gets very close. I mean you don't need to know about all litigation. For example, we have a company that closed a subsidiary and the employees are suing. It's a class action lawsuit by 2,000 out of work blue collared employees. It's going to go on for years. That's the type of thing where we need to know and ask question about. I think crossing the line is knowing the risk is $100 million, and most companies won't tell you that. [Also included in 1(b)] **[TC 12/8, p. 54]**

Participant C-13
The key to the inside information question is the materiality question. And so where you cross the line is where it becomes material. Unless the information that you're getting about the lawsuit is such that it would trigger an investment action, then it's not material. [Also included in 1(b)] **[TC 12/8, p. 55]**

Participant C-5
Doesn't disclosure in effect move the line, though? I mean as this is disclosed, it becomes public information. [Also included in 1(b)] **[TC 12/8, p. 55]**

Participant C-13
Sure, if you get a piece of material information in a management interview, you tell them to disclose it. [Also included in 1(b)] **[TC 12/8, p. 55]**

Participant C-1
The real issue that we've got is that we have to constantly wrestle with wanting more public information, where you (banks) can go in and ask someone for that information? And they know it's never going to go any further anyway. For us it's more of an issue. [Also included in 1(b)] **[TC 12/8, p. 55]**

Participant C-10
Sometimes we will get a company giving us a private placement, and then they'll put in a second package their projections. And first we're given the choice of do we want it, or sometimes they'll mail it, we'll mail it right back, because we don't want to be tied down. So we'll just work with the document that doesn't have the projections, and say we don't want it. Because otherwise we end up signing a letter of confidentiality, and our lawyers give us all sorts of hassle about how long that says we're tied down. There is a big issue here legally in terms of how far are you tied down and when are you released? [Also included in 1(c), 12, and 18(b)] **[TC 12/8, p. 72]**

One of the objectives of financial reporting is to provide information to analysts, investors, creditors and others that is useful in making investment, credit and other financial decisions. The questions in this section relate to the analysis of financial information and [analysts'] views relating to the importance and usefulness of various financial disclosures. [Also included in 1(b), 1(c), 4, and 10(d)] **[KPMG BANK STUDY, p. A-16]**

- **As part of your analysis of an institution, select one of the following letters that best describes the reason for adjusting the following financial instruments to fair value:**
  - **a. To evaluate the institution's earnings**
  - **b. To evaluate the institution's capital**
  - **c. Combination of a. and b.**
  - **d. No reason to adjust to fair value**
  - **e. No response**

A	B	C	D	E	
3%	60%	23%	10%	4	Equity investments securities
10	53	23	13	1	Debt investment securities
13	35	23	25	4	Purchased mortgage servicing rights
15	30	20	30	5	Excess mortgage servicing rights
15	30	18	35	2	Loans
5	28	18	45	4	Demand deposits
5	30	20	40	5	Time deposits
5	45	18	30	2	Long term debt
8	38	18	33	3	Financial guarantees
3	35	18	40	4	Commitments to extend credit
3	33	20	40	4	Letters of credit
5	40	25	23	7	Swaps, options, futures, etc.
0	0	0	0	0	Other

[Also included in 4] **[KPMG BANK STUDY, p. A-16]**

Estimates of fair value may vary by institution because of different assumptions, methodologies and the practicability of such disclosure. The following questions relate to the reliability and comparability of fair value estimates: [Also included in 1(b), 1(c), 2(b), and 4)] **[KPMG BANK STUDY, p. A-20]**

1(d). Other--Page 13

- **Detailed guidance on how to estimate fair values does not exist. Indicate how important detailed guidance is to the fair value estimation process.**

  73% Very important
  25 Important
  2 Not important
  0 No opinion

  Provide any additional comments:

  Not important. The cookbook approach wont work. Also, loan-by-loan opinions will be used, and are subject to huge variations of value.
  [Also included in 4)] **[KPMG BANK STUDY, p. A-22]**

1.2.15 Perceived Key Users of Financial Information

When asked to state just how important 12 different types of users of financial information are to them, those surveyed gave a clear priority to external users and investors:

Table 1.9

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS

	1985	1980
	%	%
Highly Important User:		
Security analysts	82	75
Present institutional investors	82	87
Potential institutional investors	81	79
Securities and Exchange Commission	77	62
Investment bankers and underwriters of new stock and bond issues	75	74
Bank loan departments	57	61
Potential individual investors	39	61
Internal company planners and managers	35	63
Present individual investors	33	72
Stockbrokers	22	33
Other federal agencies and policymaking bodies, including Congress	17	14
Reporters from newspapers and magazines covering business and financial matters	13	21

Following is a breakdown by 1985 respondents of the estimated importance of users of financial reports.

Table 1.10

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

Q.3A—Do you think . . . (READ EACH ITEM) . . . are highly important users of financial reports, somewhat important, not very important, or not important at all?

		Large Public Companies		Small Public Companies	Private Companies			Large Accounting Firms						
				C. E. O.										
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Present individual investors														
Highly important	33	42	37	27	36	20	25	38	27	53	33	26	42	35
Somewhat important	44	38	41	42	54	39	46	49	67	33	47	71	34	47
Not very important	20	15	23	27	7	37	30	13	7	13	20	3	24	12
Not important at all	2	4	–	3	4	5	–	–	–	–	–	–	–	6
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

Table 1.10 (continued)

1.d.16

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies (C.E.O.)	Private Companies (C.E.O.)	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Potential individual investors														
Highly important	39	45	42	42	50	24	26	40	27	67	27	48	37	41
Somewhat important	43	44	37	45	32	44	52	42	67	13	47	45	45	41
Not very important	16	9	22	12	14	27	20	18	7	20	27	6	18	12
Not important at all	1	3	–	–	4	5	–	–	–	–	–	–	–	6
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Present institutional investors														
Highly important	82	85	82	73	82	83	84	80	80	87	73	84	84	76
Somewhat important	16	14	16	21	11	17	13	20	20	13	27	16	16	24
Not very important	1	1	1	–	4	–	2	–	–	–	–	–	–	–
Not important at all	*	–	–	3	4	–	–	–	–	–	–	–	–	–
Not sure	*	–	–	3	–	–	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Potential institutional investors														
Highly important	81	86	81	73	79	85	82	73	73	93	53	81	84	76
Somewhat important	17	13	16	21	14	15	15	24	27	7	40	19	13	24
Not very important	1	–	1	–	4	–	–	2	–	–	7	–	3	–
Not important at all	1	1	1	3	4	–	2	–	–	–	–	–	–	–
Not sure	*	–	–	3	–	–	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Security analysts														
Highly important	82	87	78	88	79	85	87	84	80	93	80	68	82	76
Somewhat important	15	10	20	9	18	12	10	16	20	7	20	29	16	24
Not very important	1	1	1	3	–	2	–	–	–	–	–	3	3	–
Not important at all	1	1	–	–	4	–	2	–	–	–	–	–	–	–
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–

[HARRIS]

1.2.17

Table 1.10 (continued)

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Bank loan departments														
Highly important	57	55	56	52	57	56	82	49	47	47	53	58	39	59
Somewhat important	36	38	34	42	43	32	15	44	53	47	33	35	50	35
Not very important	4	3	8	3	–	5	2	7	–	7	13	6	8	–
Not important at all	1	3	1	3	–	2	–	–	–	–	–	–	3	–
Not sure	1	1	1	–	–	5	–	–	–	–	–	–	–	6
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Investment bankers and underwriters of new stock and bond issues														
Highly important	75	78	73	70	71	73	82	73	67	80	73	84	66	71
Somewhat important	21	18	22	24	25	22	11	27	33	20	27	16	32	29
Not very important	3	4	4	6	–	2	3	–	–	–	–	–	3	–
Not important at all	1	–	1	–	4	–	2	–	–	–	–	–	–	–
Not sure	*	–	–	–	–	2	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Securities and Exchange Commission														
Highly important	77	74	72	79	75	71	84	84	80	93	80	71	79	82
Somewhat important	18	14	23	15	14	20	13	16	20	7	20	29	16	18
Not very important	3	5	4	6	7	5	–	–	–	–	–	–	–	–
Not important at all	2	5	1	–	4	–	–	–	–	–	–	–	5	–
Not sure	1	1	–	–	–	5	2	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Other federal agencies and policymaking bodies, including Congress														
Highly important	17	14	11	15	21	22	25	18	20	20	13	10	8	35
Somewhat important	49	44	54	39	36	44	52	49	47	53	47	58	61	41
Not very important	26	37	23	30	32	22	16	24	27	20	27	19	29	18
Not important at all	6	4	11	12	11	2	2	7	7	–	13	3	3	–
Not sure	3	1	–	3	–	10	3	2	–	7	–	10	–	6
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–

[HARRIS]

C.2.18

Table 1.10 (continued)

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Stockbrokers														
Highly important	22	17	19	30	21	27	33	18	20	27	7	16	21	29
Somewhat important	53	55	57	52	57	46	46	51	47	73	33	55	50	59
Not very important	21	21	24	18	14	20	18	29	27	–	60	26	24	6
Not important at all	3	6	–	–	4	5	2	2	7	–	–	3	5	6
Not sure	1	1	–	–	4	2	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Internal company managers and planners														
Highly important	35	29	32	36	29	34	44	38	40	40	33	39	29	47
Somewhat important	42	46	51	33	29	44	41	44	40	53	40	52	32	24
Not very important	18	22	14	27	21	17	11	16	13	7	27	6	32	18
Not important at all	4	3	4	3	21	2	2	2	7	–	–	3	8	6
Not sure	*	–	–	–	–	2	–	–	–	–	–	–	–	6
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Reporters from newspapers and magazines covering business and financial matters														
Highly important	13	8	10	12	11	15	20	16	13	27	7	3	16	41
Somewhat important	53	59	54	52	64	49	44	49	60	47	40	58	53	53
Not very important	27	29	27	30	18	24	30	31	20	20	53	32	29	–
Not important at all	6	4	6	6	7	12	5	4	7	7	–	6	3	6
Not sure	*	–	3	–	–	–	–	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–

*Less than .5%.

Striking is the fact that security analysts, present and potential institutional investors, the SEC, and investment bankers and underwriters of new stock and bond issues all dominate the list as the most important. This undoubtedly reflects both the importance that is given to the investment function and also to external users in today's markets.

Equally significant is the obvious fall from grace of the current individual investor, who has dropped from 72% to 33% in high importance since 1980, and potential individual investors who have gone down from 61% to 39% over the past five years.

All other users are viewed as quite far down the list in high importance in the estimates of these articulate members of the constituencies and the observers of the work of the FASB.

[HARRIS]

1.2.19 In fairness to this community, however, it must be pointed out that these estimates reflect the way they believe it is today, not necessarily the way it ought to be. This was evident when the sample was asked to pick the two or three most important types of users today and who they felt should be the most important users.

Table 1.11

WHO ARE AND SHOULD BE THE MOST IMPORTANT USERS OF FINANCIAL REPORTS

	Most Important	
	Are Today	Should Be
	%	%
Security analysts	58	45
Present institutional investors	57	49
Bank loan departments	32	28
Potential institutional investors	31	27
Investment bankers and underwriters of new stock and bond issues	24	21
Securities and Exchange Commission	24	17
Present individual investors	18	32
Potential individual investors	14	28
Internal company planners and managers	9	13
Stockbrokers	2	2
Other federal agencies and bodies, including Congress	1	1
Reporters from newspapers and magazines covering business and financial matters	1	2
None	*	–
Not sure	1	2
No answer	*	*

*Less than .5%.

Observation: *Clearly, these knowledgeable people are not satisfied with their estimate of the status quo as far as individual investors are concerned. Indeed, compared with 18% who feel that present individual investors are among the most important users of financial reports, a much higher 32% believe they should be important users. In the case of potential investors, 14% viewed them as among the most important users today, but a much higher 28% think they should be.*

[HARRIS]

1.2.20

Following is a breakdown by respondents of who are and who should be the most important users of financial reports.

Table 1.12

WHO ARE THE MOST IMPORTANT USERS OF FINANCIAL REPORTS TODAY: BREAKDOWN BY RESPONDENTS

Q.3B—Which of the following do you feel today are the most important users of financial reports?

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers					Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Present individual investors	18	27	14	15	25	15	3	20	7	33	20	23	24	12
Potential individual investors	14	14	13	15	14	5	7	27	7	47	27	19	24	12
Present institutional investors	57	71	63	33	57	80	46	40	40	47	33	42	55	59
Potential institutional investors	31	42	46	36	18	29	10	27	20	27	33	16	26	53
Security analysts	58	73	62	52	46	66	57	49	67	33	47	26	66	47
Bank loan departments	32	12	16	36	46	7	79	44	53	40	40	55	16	18
Investment bankers and underwriters of new stock and bond issues	24	14	24	15	32	32	36	24	47	7	20	35	13	24
Securities and Exchange Commission	24	17	24	18	29	12	25	31	33	13	47	35	29	41
Other federal agencies and policymaking bodies, including Congress	1	–	1	–	4	2	–	–	–	–	–	–	–	6
Stockbrokers	2	1	–	9	–	7	–	–	–	–	–	–	–	6
Internal company managers and planners	9	8	8	9	11	5	13	11	7	20	7	16	5	6
Reporters from newspapers/magazines covering business and financial matters	1	1	–	–	–	5	–	–	–	–	–	–	–	12
None	*	–	–	3	–	–	–	–	–	–	–	–	–	–
Not sure	1	–	3	–	–	–	2	–	–	–	–	–	5	–
No answer	*	–	–	3	–	–	–	–	–	–	–	–	3	–

*Less than .5%.

[HARRIS]

1.2.31

Table 1.13

WHO SHOULD BE THE MOST IMPORTANT USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

Q.3C—Which of the following do you feel should be the most important users of financial reports?

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies (C. E. O.)	Private Companies (C. E. O.)	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Present individual investors	32	38	28	45	39	27	15	29	20	27	40	29	47	41
Potential individual investors	28	24	28	42	25	17	18	42	33	60	33	29	34	41
Present institutional investors	49	63	57	18	57	68	46	31	20	40	33	32	45	47
Potential institutional investors	27	28	39	33	18	34	10	31	27	33	33	16	24	35
Security analysts	45	55	43	33	39	54	46	42	53	33	40	23	53	35
Bank loan departments	28	10	20	18	39	7	66	44	60	40	33	55	8	6
Investment bankers and underwriters of new stock and bond issues	21	18	18	9	21	24	33	22	33	13	20	32	13	18
Securities and Exchange Commission	17	13	15	24	25	20	15	11	7	7	20	26	18	18
Other federal agencies and policymaking bodies, including Congress	1	–	3	–	–	5	2	–	–	–	–	–	3	–
Stockbrokers	2	3	4	3	–	5	2	–	–	–	–	–	3	6
Internal company managers and planners	13	12	11	27	18	7	13	11	13	13	7	26	5	–
Reporters from newspapers/magazines covering business and financial matters	2	3	1	–	–	–	–	–	–	–	–	–	5	18
None	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Not sure	2	1	4	–	–	2	3	–	–	–	–	–	5	6
No answer	*	–	–	3	–	–	–	–	–	–	–	–	3	–

*Less than .5%.

[HARRIS]

2. Qualitative Aspects of External Reporting

Data Base Code		Data Base Code	
SRI	■	S&P	□
RMA90	■	BETRIOU	■
RMA92	□	R.G. ASSOCIATES	□
FASOversight	■	HARRIS	■
AIMR/CIC90	□	TI 10/16	■
AIMR/CIC91	■	PMQI 10/16	□
AIMR/CIC92	■	TI 12/9	■
AIMR/FAF91	■	PMQI 12/9 and 1/13	■
AIMR FIN SER INDUSTRY	□	TI 1/13	■
AIMR/FAPC92	■	TI 3/17	■
LYNCH	□	PMQI 3/17	■
KPMG BANK STUDY	■	TC 12/8	■
BEAR STEARNS	■	PMQC 12/8	■
GOLDMAN	■	TC 2/2	■
FREEDMAN	□	PMQC 2/2	□
PREVITS	■	TC 3/11	■
HILL KNOWLTON	■	PMQC 3/11	■
TOWERS PERRIN	□	TMKT 4/7	□

2(a). Relevance

> [Companies] "don't discuss problems candidly. They don't discuss the future of the company clearly." (Boston mutual fund analyst) [Also included in 13] **[HILL KNOWLTON, p. 6]**

> "Companies convey as little as they can. Annual reports tend to be bland and rose-tinted. . . . Most of them gloss over too much." (Los Angeles mutual fund analyst) **[HILL KNOWLTON, p. 7]**

[Context] The AIMR position paper provides a two-paragraph summary of the section (pages 20-23) entitled "Qualitative Characteristics of Financial Statements." The second paragraph pertains to timeliness of information:

> Some attention is paid in this section to the need for timely reporting. It introduces the view of AIMR that mandated quarterly reporting not only is essential, but that moves to abolish it appear to be based on incorrect premises, blaming quarterly reporting requirements for "short-termism" when the blame can better be placed elsewhere. [Also included in 2(b)] **[AIMR/FAPC92, p. vii]**

[Context] Because they have that focus, excerpts on timeliness, which normally would be included in 2(a)-Relevance (of which timeliness is a subset in FASB's concepts statements), are included in 11(a)-Frequency of interim reporting.

The first paragraph is as follows:

> The qualitative characteristics of accounting that we find most important to the needs of financial analysts are relevance, reliability, both verifiability and representational faithfulness, timeliness and neutrality. First, analysts need to know economic reality -- what is really going on -- to the greatest extent it can be depicted by accounting numbers. The information must be relevant to the process of analysis, one reason why much space in the early part of the report is devoted to describing the analyst's work. [Also included in 2(b)] **[AIMR/FAPC92, p. vii]**

[Context] It introduces the following excerpts on relevance:

> There is general agreement that accounting and other financial data should have certain characteristics. The FASB's Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," creates two groups of these characteristics under the headings "relevance" and "reliability." That grouping is appropriate because in many cases the format and content of accounting data requires a trade-off between the two. Certainly, financial analysts desire information that is both relevant and reliable, but their bias is towards relevance. In a phrase, analysts prefer information that is equivocally right rather than precisely wrong. Inexact measures of contemporaneous economic values generally are more

useful than fastidious historic records of past exchanges. A short discussion of several characteristics of accounting quality and our views of them follows. [Also included in 2(b)] **[AIMR/FAPC92, p. 20]**

Relevance
In an ideal world, the most relevant accounting data would be those that reported assets and liabilities in a way that would allow analysts to impute the future cash flows emanating from them individually and collectively. The certainty embodied in that world does not exist. In fact, if it did, there would be no need for analysis. Therefore, we must strive for an accounting model that reflects the degree of uncertainty that besets a particular enterprise, the consequence of which is a valuation system that is eclectic. Some assets, such as receivables, are stated explicitly at the amounts expected to be received in cash. Other assets, such as certain types of securities, are stated at market value, implicitly the amount of cash that could be received. Some assets are stated at the amounts paid for them (historic cost) pending receipt of evidence that they are worth some other amount (realization). Some assets may not appear in the financial statements at all because there is no sensible way to report them. **[AIMR/FAPC92, p. 20]**

Historic costs are sunk costs and there is little disagreement that they are often irrelevant to financial decisions. But there is considerable debate as to whether they should be totally replaced by more relevant current values, whether current values should be provided only as supplementary data, what version of current value should be used, and how (in the absence of a firm-specific exchange or and organized auction market) current value should be determined. There also is some opinion among analysts that determination of the current values of specific assets is a function of financial analysis, not financial reporting. However, almost all would agree that so-called lower of cost or market methods are neither informative nor useful. They are based on the untenable premise that market value is a good accounting measure when it is lower than historic cost, but not when it is higher. The best argument that can be made in favor of lower of cost or market is that it does reveal market values when they are lower than cost, thus divulging important information on a variety of asset impairments. **[AIMR/FAPC92, p. 20-21]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting. During the discussion, an investor commented on the lack of relevance of the 10Qs.

Participant I-11
One of my problems with present 10Qs is that they show the period-end balance sheet and the balance sheet for the preceding fiscal year-end instead of the balance sheet for the 12 month earlier. If there is any seasonality, that can be a terribly distorting factor. [Also included in 11(c)] **[TI 3/17, p. 41]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on the relevance of information.

Participant C-14
I perceive a lot of the overload to be in the footnotes, but I also find the footnotes to be the most useful part of the financial statements. And I tried to think of how to enhance the understandability of that information, and I think we started to touch on it when we said well, in the footnotes you find the nominal amount of the swaps, but you really don't know what the impact could be. We also need information on the assumptions used by a company or the reasoning for the assumptions they chose in their accounting methods. For instance, why did [one company] pick a 12% return on plant assets, it's 11 or 12%, when inflation is you know, 3 or 4%? Or why did [another company] depreciate its video over 36 months when the economic life is only four months? I'd like to know more about why they choose those kind of things. Or other examples would be why they've changed accounting standards. [Also included in 1(b), 2(c), 9, and 19] **[TC 12/8, p. 41]**

Participant C-1
There is also an incentive, especially in the high yield area, not to disclose anything, because you want the value of the securities to decline so that you're able to repurchase them. And the only time you get significant information is when they want your money, and once they have it, you don't get anything. I think there is also a difference between the amount of information that's provided in a prospectus and the amount of information that you get on an ongoing basis. [Also included in 1(b)] **[TC 12/8, p. 57]**

Participant C-4
I think one of our objectives for which we need financial reporting is to determine whether or not we're going to continue to extend credit. I think our needs are also to assess our liability as a result of our extending credit. And a lot of times when we're in a distressed situation, information is not available. If the accounting reports were more standardized with some more information that's pertinent to us, then we wouldn't have to go through the process of trying to solicit information that management won't provide to us. [Also included in 1(b)] **[TC 12/8, p. 58]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on the relevance of external reporting.

Committee/Staff/Observer
[Participant C-5], one of the arguments you hear for fair value is the relevance argument. That is, fair value is always more relevant than historical cost. I think what I heard you say is

F"7

it may or may not be in your situation. Because of not knowing the assumptions that go into it, and the timeliness of it, that may not be any more relevant than other information you have. [Also included in 4] **[TC 2/2, p. 6]**

Participant C-5
For example, you could have given me a perfect real estate fair value in 1988. And knowing that the land had flipped three times in the course of the last three years, a good lender would have been smart enough to figure out it wasn't worth $500,000 then $1 million, and then a million and a half. And each time an accountant had good comparable sales, analysis and so forth, it could have given you a number showing significant increases. Realizing that this thing was getting into a disequilibrium, a lender knowing historical costs would have been smarter to focus on that than on fair value. Fair value can be misleading. . . . [T]imeliness is so critical. Even trade receivables. You could give me year-end balances but then I need to know what today's are. We advance on a weekly and a daily basis on trade receivables. [Also included in 4] **[TC 2/2, p. 6-7]**

Participant C-11
I think that if we're talking about going concerns, the need for fair value information and its reliability and usefulness, in terms of knowing how well the business is doing, is lot less and definitely that puts it into supplemental status. I think we have a great problem in general as to knowing when a company is in distress, and when we have to take a different accounting approach. So far, all the comments have been focused on revaluing at market values specific types of assets. Nobody's mentioned liabilities. But I think we can't forget that. I want to make a comment that in an increasingly distressed situation, a company doesn't have to, necessarily, sell one particular type of loan or securities or whatever. There is often an option of selling part of its business. And so when you're talking about what is the fair or market value of an entity, it isn't necessarily just individual assets. It can be a business component. And the way you value the component of the company's business is going to be a lot different then. And it may be even more successful a way to take care of a distress situation than just selling its individual loans. I think if you're thinking about market value, you have to think in a more complex way and not just value the specific individual assets and liabilities and think you've done the job. I feel strongly about that. I'd also make just a general comment about supplemental information. I don't ascribe more importance to something because it's in a footnote, as opposed to being in a supplemental schedule of some sort. We have all kinds of supplemental schedules that are required and that's where you can get some of your best data. As a user, I don't have a phobia about needing to have it on the balance sheet or a footnote, per se. [Also included in 2(b), 4, and 5(d)] **[TC 2/2, p. 7-8]**

[The CIC] oil industry subcommittees [complimented oil companies] regarding the quality and timeliness of information made available to investors and the awareness of most managements of their obligation to those who own the company. [However,] the Insurance Subcommittee, [commented]: "In general, comments from subcommittee members showed a growing frustration with the lack of candor and insight into the numerous problems of both the life and property-casualty industries provided by many insurance management teams. There is a sense that too many companies are not being managed in an effective manner. . . .It is hard to

believe, but the quality of the industry's reporting to shareholders continues to deteriorate." [Also included in 2(b) and 16(b)] **[AIMR/CIC92, p. 1]**

The following comment by [the] Chairman of the [CIC] Foreign-Based Oil Subcommittee, puts into good perspective many of the shortcomings overseas companies have in dealing with investors: "The committee felt that the area where there is most room for improvement was in the frequency and timing of interim reports and communications of business trends to investors on a timely basis. In general, quarterly/semi-annual/annual results are published much later than those of U.S. companies. The French practice, for example, is to release partial data on a timely basis (i.e. less than one month after a period's close), but not to release sector and financial details for one or even two months later. Without details, the initial release is of limited analytical value. . . . Most U.K. companies report semi-annual and do so quite awhile after the period has ended. Overall, these practices are in line with those of respective home markets but American investors, used to full detail within three to four weeks of the quarter's close, would prefer quicker and more detailed reports. [The Chairman] realize[s] there is a cost involved with doing this, but feels the market would be better informed and more efficient as a result. [Also included in 11(a), 15, and 16] **[AIMR/CIC92, p. 3]**

Focus Group Comments, Analysts: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 1(b), 1(c), 2(b), and 4] **[KPMG BANK STUDY, p. 39]**

- Moderately supported fair value disclosures; some indicated that such disclosures would be of little use, or even misleading [Also included in 4] **[KPMG BANK STUDY, p. 39]**
- Indicated concern over the amount of subjectivity involved in making fair value estimates and questioned the ultimate usefulness of the results [Also included in 2(b) and 4] **[KPMG BANK STUDY, p. 39]**

The quality and usefulness of the information available to the public is an integral part of the analysis of a financial institution's performance and of its estimated value. The questions in this section address the usefulness of the existing financial information and [analysts'] views toward enhancing such information: [Also included in 1(b), 2(d), 4, and 15] **[KPMG BANK STUDY, p. A-3]**

2(a). **Relevance--Page 6**

- **Indicate the importance of the following current financial statement disclosures.**

	Very Important	Important	Not Important	No Response
Net interest spread	85%	13%	2	
Regulatory capital adequacy	70	30		
Liquidity	35	53	10	2
Interest rate management	48	50	2	
Credit quality	95	5		
Investment portfolio maturities	15	68	17	
Investment portfolio yields	23	60	17	
Unrealized gain and loss disclosures	43	55	2	
Loan concentration	83	15	2	
Contractual loan maturities	3	53	44	
Fixed vs. variable rate loan information	18	65	17	
Loan portfolio yields	33	60	7	
Non-accrual, past due and restructured loans	100			
Other potential problem loans	93	7		
Charge-off and recovery experience	85	15		
Allocation of allowance by loan type	35	40	20	5
Deposit mix	40	53	7	
Off-balance-sheet instruments	23	70	5	2
Five-year summary data	43	45	5	7
Other (principally includes intangibles and segment data)	21	6		

[Also included in 1(b)] **[KPMG BANK STUDY, p. A-3]**

The FASB, the Securities and Exchange Commission (SEC) and other regulatory bodies are currently considering a requirement to prepare financial statements based on market values in place of financial statements prepared on a historical cost accounting basis. The questions in this section relate to this issue: [Also included in 1(b), 2(b), 2(c), 4, 10(b), 11(a), and 15] **[KPMG BANK STUDY, p. A-9]**

- **Indicate whether you believe fair value accounting should be the primary accounting basis for the preparation of an institution's financial statements.**

10% Yes
90 No

] 0 No opinion
[Also included in 2(b), 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Grave doubts exist as to the usefulness and accuracy of estimates of 'fair value'. [Also included in 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] yes. Most realistically reflects market value of company's equity - market now guesses at the value - greater disclosure will result in more efficient pricing of stocks. Also, will force management to take into account information from the market - e.g. declining value of real estate loans might have shut off real estate lending spigot sooner. [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-10]**

- **There are current accounting rules that require the disclosure of fair values, realized and unrealized gains and losses, cash flow information and maturities and yields of investment securities. Considering that this information is already available, indicate whether you believe the historical cost based accounting should be replaced with fair value based accounting.**

8%	Yes
88	No
2	No opinion
2	No response

[Also included in 2(b), 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. Much of the additional information that would be available with fair value accounting must be based on estimates which are likely to incorporate varying assumptions and therefore, is unlikely to be reliable or consistent. Further, much of what is proposed is irrelevant for valuing a banking company. [Also included in 2(b), 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-11]**

2.a.9 Relevance and Reliability

As in the 1980 survey, key FASB constituents and observers were asked about the question of relevance and reliability in reporting financial information. First, they were asked if at some point one of these qualities might have to be sacrificed in order to gain the other:

Table 4.5

WHETHER RELEVANCE OR RELIABILITY SHOULD BE SACRIFICED

Q.12D—In an ideal world, all financial information would be both relevant and reliable. But, in the world of *reality*, do you agree or disagree that there are times when one of these qualities has to be sacrificed some in order to gain the other?

	1985	1980
	%	%
Agree sacrifice sometimes needed	59	41
Disagree, not needed	38	54
Not sure	2	5

In the five-year period since 1980, a dramatic turnabout in attitudes obviously has taken place. Back in 1980, a majority did not think it necessary sometimes to sacrifice relevance or reliability for the other. Now, a clear majority feels that it is necessary to do so at times.

Following is a breakdown by 1985 respondents on whether a sacrifice of relevance or reliability is sometimes needed.

Table 4.6

SACRIFICING RELEVANCE OR RELIABILITY: BREAKDOWN BY RESPONDENTS

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Agree	59	54	63	61	61	44	48	76	93	53	80	48	84	59
Disagree	38	46	37	36	39	44	49	22	7	40	20	45	16	41
Not sure	2	–	–	3	–	12	3	2	–	7	–	6	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

2.2.10

When asked to choose, as in 1980, a substantial majority would sacrifice relevance for reliability:

Table 4.7

WHETHER RELEVANCE OR RELIABILITY CAN BE COMPROMISED

Q.12E—In general, if you had to choose, which do you think ought to be compromised if either some relevance or reliability had to be sacrificed—*relevance or reliability?*

	1985	1980
	%	%
Relevance	65	65
Reliability	23	16
Both	3	3
Neither	2	*
Not sure	6	16

*Not measured in 1980.

Observation: *As in 1980, a sizable majority would opt to sacrifice relevance if a choice has to be made, but a slightly larger portion of the sample would be willing to sacrifice reliability in 1985.*

Following is the 1985 breakdown by categories of respondents.

Table 4.8

RELEVANCE VS. RELIABILITY: BREAKDOWN BY RESPONDENTS

		Large Public Companies		Small Public Companies (C.E.O.)	Private Companies (C.E.O.)			Large Accounting Firms						
BASE: TOTAL RESPONDENTS	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Relevance	65	63	59	79	75	80	79	60	40	80	60	71	29	53
Reliability	23	18	30	15	14	7	8	36	53	13	40	16	63	29
Both	3	9	3	3	–	–	–	–	–	–	–	3	5	–
Neither	2	4	1	3	–	2	3	–	–	–	–	3	–	12
Not sure	6	5	6	–	11	7	10	4	7	7	–	6	3	6
No answer	*	1	–	–	–	2	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

2(b). Reliability and Neutrality, including Conservatism and Volatility

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to criticisms of financial reporting. . . . **[FASOversight, p. 1]**

- The expected financial reporting result of a proposed transaction often influences management behavior; financial reporting should report the results of economic decisions, not drive such decisions. **[FASOversight, p. 1]**

The standard-setting process should be even-handed. The process (and the pronouncements resulting from it) should be free from bias and designed to withstand pressures, political and otherwise, from outside parties. **[RMA90, p. 2]**

Understandability is an important characteristic of accounting data. The [following item] listed below [is] vital to understandability. **[RMA90, p. 3]**

- Conceptual support: Financial accounting standards should emanate from a sound conceptual framework that ensures consistency, comparability and neutrality. [Also included in 2(c)] **[RMA90, p. 3]**

The APC [Accounting Policy Committee] has considered and expresses below its opinions on a number of specific issues affecting financial accounting standards and financial reports. The APC believes that the following items should be included in the single body of accounting concepts, standards, principles and methods: **[RMA90, p. 5]**

- Accruals and deferrals are necessary for proper matching to occur, and by their nature deferrals, which require allocations, and accruals, which require estimates of future expenditures, are arbitrary and imprecise. Therefore, care must be taken to see that their use not be extended to permit "normalization" of earnings in any accounting period, annual or interim. Normalization, like forecasts and projections, is the province of the financial statement user and should not be incorporated into financial reporting. [Also included in 5(a)] **[RMA90, p. 5-6]**

- Conservatism is a doctrine that serves users of financial statements well and should be observed consistently by financial statement preparers. It is difficult to define, but its spirit is contained in the following two statements: (1) "Recognize all losses when they occur,

> but do not recognize gains until they are realized."; (2) "When in doubt, err on the side of undervaluing assets and overvaluing liabilities." Conservatism is, of course, antithetical to the notion that accounting should be even-handed and free from bias. **[RMA90, p. 6]**

[C]redibility is . . .the most serious problem for the annual report, in that investors often distrust what companies tell them in their annual reports. **[HILL KNOWLTON, p. 6]**

More than nine out of ten of the professional investors polled -- 92 percent -- said that annual reports all too often fail to candidly discuss bad news, and problems, and what management is doing to solve them. **[HILL KNOWLTON, p. 6]**

[Seventy-three] percent of the individual investor [polled] agreed that annual reports often play down bad news or hide it in the back of the report. **[HILL KNOWLTON, p. 6]**

[Thirty-two] percent [of individual investors] agreed with the statement, "I don't trust what I read in annual reports." **[HILL KNOWLTON, p. 6]**

An Atlanta investor commented: "In general, bad news is disguised, and good news is overplayed." Added a Tampa investor: "I don't trust what I read in annual reports . . .because I believe that the company is putting themselves in a favorable light." **[HILL KNOWLTON, p. 6]**

A Baltimore security . . . analyst said: "There's not enough honesty in annual reports. Too often, the blame for mistakes is placed outside the company, and management won't take responsibility." **[HILL KNOWLTON, p. 6]**

"I look at the (Form) 10-K to make sure the annual report isn't full of lies. . . . (St. Louis brokerage firm analyst) **[HILL KNOWLTON, p. 7]**

> "You know the company is in trouble when they show 20 or 30 photos of children at play and no footnotes [in their annual report]." (Hartford investment counseling firm analyst) **[HILL KNOWLTON, p. 7]**

"Write [annual reports] like they're being written for someone who owns the company. Make 'em frank and honest." (Chicago mutual fund analyst) **[HILL KNOWLTON, p. 7]**

To all types of investors, the credibility of an annual report, or any other information source, depends on the degree to which it is correct, complete, and objective. **[SRI, p. 59]**

The credibility question is focused primarily on the front half of the annual report, the narrative part, which is subject to less rigorous scrutiny by regulators and auditors offers wide latitude to management on inclusion (or exclusion) and presentation of information. The back half, the financial statements and footnotes, is perceived to offer less latitude for presentation of information and is considered to be much more credible than the front half. **[SRI, p. 59-60]**

As shown in [the] table [below], investors believe that many company managements are not forthright when reporting problems and poor company performance, that much of the information they disseminate is too "promotional," and that troubled companies take great pains to convey the impression that they are not seriously troubled. The investors do not believe that management tells outright lies in its information reporting except in unusual cases. They do believe, however, that executives strive to present their situations in the best possible light, delay reporting negative information in the expectation (hope?) that the situation will soon be corrected, or are simply so involved with the company that they report biased information without realizing it. Very few investors, however, doubt the integrity of corporate management, yet, for the reasons outlined above, most believe that corporate reporting is not objective. It is this perception that makes "objectivity" one of the components of the value of investment information. **[SRI, p. 60]**

Individuals believe that the credibility of annual reports is analogous to that of advertising. Even though advertising tells the literal truth, certain ads can mislead through omissions, half-truths, out-of-context statements, and the like. When times are good for a company, they believe that the firm's annual report is highly credible. When the company has problems, they seek objective corroboration or the advice of competent analysts. This questionable credibility is one reason that individual investors (and professionals as well) use so many different sources of information. **[SRI, p. 60]**

Questionable credibility is not perceived as a problem for most investors, however; they expect it, and they find ways to overcome it. They recognize the natural biases of management and subjectively make appropriate adjustments. They rely heavily on other information sources for decision making. The professionals, especially, are confident of their ability to recognize exaggerations, favorable accounting treatments, and significant omissions. **[SRI, p. 60]**

Even though investors do not regard questionable credibility as a major problem, issuers of annual reports should take it seriously for three reasons. Firstly, management exacerbates rather than enhances its image by glossing over problems and poor performance. A noncredible annual report raises the question of management credibility in general, and can even cast a shadow on management competence. Despite some short-term discomfort, full disclosure will, in most cases, actually enhance management credibility. Secondly, the professionals are irritated that some executives seem to regard them as gullible enough to believe that all is well when in fact all is not well. Finally, those few companies whose annual reports are considered to be highly credible (Berkshire Hathaway and Quaker Oats are frequently cited examples) earn high marks and expressions of great respect from professional investors. **[SRI, p. 60&62]**

The Credibility of Annual Reports

Statement	*Individual Investors*			*Professional Investors*		
	Agree	*Neutral*	*Disagree*	*Agree*	*Neutral*	*Disagree*
"Most annual reports are candid in their discussion of company performance."	15.4%	41.3%	36.3%	13.8%	41.0%	45.2%
"Annual reports are written to project the most favorable impression of company management."	86.4	11.1	2.2	85.6	11.2	3.2
"Annual reports would be more useful to me if the management discussion was frank about reporting poor company performance."	84.9	10.9	2.5	88.1	8.0	3.8
"Annual reports would be more useful to me if they were less promotional."	44.8	32.9	21.7		- not asked -	

Source: SRI International survey, 1986. **[SRI, p. 61]**

[Sometimes,] earnings quality . . . seem[s] to be related to "representational faithfulness," and management's forthrightness in disclosure. For example, one analyst reported that an extreme drop in the reported tax rate of a company "caused some to doubt the quality of (its) earnings". Another expressed concern about earnings quality on the basis of the amount of costs included by a company in the determination of cost of goods sold. [Also included in 1(b), 1(c), and 5(a)] **[PREVITS, p. 16]**

[Context] The AIMR position paper provides a two-paragraph summary of the section (pages 20-23) entitled "Qualitative Characteristics of Financial Statements." The second paragraph pertains to timeliness of information:

Some attention is paid in this section to the need for timely reporting. It introduces the view of AIMR that mandated quarterly reporting not only is essential, but that moves to abolish it appear to be based on incorrect premises, blaming quarterly reporting requirements for "short-termism" when the blame can better be placed elsewhere. [Also included in 2(a)] **[AIMR/FAPC92, p. vii]**

[Context] Because they have that focus, excerpts on timeliness, which normally would be included in 2(a)-Relevance (of which timeliness is a subset in FASB's concepts statements), are included in 11(a)-Frequency of interim reporting.

The first paragraph is as follows:

> The qualitative characteristics of accounting that we find most important to the needs of financial analysts are relevance, reliability, both verifiability and representational faithfulness, timeliness and neutrality. First, analysts need to know economic reality -- what is really going on -- to the greatest extent it can be depicted by accounting numbers. The information must be relevant to the process of analysis, one reason why much space in the early part of the report is devoted to describing the analyst's work. [Also included in 2(a)] **[AIMR/FAPC92, p. vii]**

[Context] It introduces the following excerpts on reliability and neutrality:

> There is general agreement that accounting and other financial data should have certain characteristics. The FASB's Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," creates two groups of these characteristics under the headings "relevance" and "reliability." That grouping is appropriate because in many cases the format and content of accounting data requires a trade-off between the two. Certainly, financial analysts desire information that is both relevant and reliable, but their bias is towards relevance. In a phrase, analysts prefer information that is equivocally right rather than precisely wrong. Inexact measures of contemporaneous economic values generally are more useful than fastidious historic records of past exchanges. A short discussion of several characteristics of accounting quality and our views of them follows. . . . [Also included in 2(a)] **[AIMR/FAPC92, p. 20]**
>
> Reliability: General
> The two primary components of reliability are verifiability and representational faithfulness. The former refers to the likelihood that different accountants, availing themselves of the same evidence, will draw similar conclusions. The latter refers to the likelihood that the accounting measure depicts accurately the nature of the object being measured. **[AIMR/FAPC92, p. 21]**
>
> Reliability: Verifiability
> This characteristic is intimately related to the attest function. For financial reports to be useful, they must be trustworthy. The report of the independent auditor is essential. The auditor however can verify only that which can be documented or confirmed. Perhaps that is one reason for the extensive amount of detailed guidance provided with current accounting standards. As the standards-setting process has infiltrated areas in which the measurements are less than precise (pensions and other postemployment benefits, financial instruments, recognition of fee revenues, etc.) the rules have become more detailed. Detailed rules may also be perceived as necessary to serve the needs of both financial statement preparers and their independent auditors. Verifiability implies that two unrelated parties considering the same facts independently will draw similar conclusions. It is possible that detailed rules are

now the only way to inculcate verifiability into measurements that otherwise are subject to honest differences of opinion. Can better ways be found? We hope so and are heartened by the issuance of FASB Statement 109, "Accounting for Income Taxes," which we regard as a step in the right direction. **[AIMR/FAPC92, p. 21]**

Another aspect of verifiability is knowledge of its absence. Most accounting numbers have an appearance of precision. But, other than contemporaneous exchanges involving cash, accounting numbers are determined by estimates of various degrees of inexactitude. Analysts need to know how indefinite those numbers are and they need to know the degree to which the same economic event or condition could have been reported differently using alternative measurement methods. More information of that sort incorporated in financial reports would be exceedingly welcome. [Also included in 9] **[AIMR/FAPC92, p. 21]**

Reliability: Representational Faithfulness
Assets and liabilities are probable future economic benefits and claims against those benefits, and users of financial statements expect to see them depicted accurately. There are two aspects to representing them faithfully. One is to select the appropriate attribute to measure; the other is to measure it accurately. There are too many examples to cite them all, but one may be instructive. **[AIMR/FAPC92, p. 21]**

Under current accounting practice, intangible assets are recorded at cost only when they are purchased from another entity, either separately or as part of a business combination. The effect is that self-developed intangibles are not recorded at all or at the nominal amounts spent to assure monopoly rights. Furthermore, the costs of both purchased and self-developed intangibles are amortized over arbitrary future time spans, even though their value may decrease in some other pattern or, in many cases, increase as the enterprise makes additional expenditures to maintain and/or enhance their value. Those accounting practices cause severe noncomparability between and among companies. **[AIMR/FAPC92, p. 21-22]**

Also, regardless of whether intangibles are recorded at the cost of purchasing them or at the nominal amounts to develop them internally, many of the future benefits to be obtained from them are more speculative and conjectural than those to be received from tangible assets which at least may have some value in alternative use. So, only at the date on which purchased intangibles are acquired do the financial statements assuredly reflect amounts that can purport to be representationally faithful of economic reality. Moreover, there may well be no accounting measure that is capable of expressing well over time that the sole economic benefit of intangible assets is their potential contribution to the future cash flows of the enterprise. Our specific recommendations for accounting for intangible assets are discussed later in this report. **[AIMR/FAPC92, p. 22]**

Neutrality
In addition to timely dissemination, fairness also requires neutrality, presentation of data that are without bias. Investors both buy and sell securities. Financial reports should inform both sides of a transaction in such a way that neither is favored. Much of what applies here was discussed above under the heading of relevance. Historic costs, even more so lower of cost or market procedures, tend to introduce bias in favor of buyers of securities by suppressing good news while revealing the bad straightaway. The absence of adjustments to reflect price

changes, even as supplementary information only, in North American accounting standards institutes a bias that varies in proportion to: (a) the rate of price change; (b) the dispersion of those changes among the various goods and services traded; and (c) the holding period for assets whose prices change. **[AIMR/FAPC92, p. 23]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on the reliability of value information.

Committee/Staff/Observer
[Participant I-12] said that part of determining fair value depends on what your expectations are as to how you are ultimately going to realize the asset or settle a liability. Even if you want to adjust the information you receive, why wouldn't you want to know what management's expectations are with respect to fair value? [Also included in 4] **[TI 1/13, p. 16-17]**

Participant I-12
Management lies all the time. [Also included in 4] **[TI 1/13, p. 17]**

Committee/Staff/Observer
So it's a reliability issue? [Also included in 4] **[TI 1/13, p. 17]**

Participant I-12
Yes. [Also included in 4] **[TI 1/13, p. 17]**

Participant I-10
Have you ever seen a management who thought that their stock was overvalued? With fair value, you're giving them a platform to induce people to believe that there is an enormous gap between what the market price is and what they believe the business is worth. I think that plenty of room would be given for deception. Not everyone is a professional investor; there are millions of people who believe what they read! It's somewhat dangerous. [Also included in 4] **[TI 1/13, p. 17]**

Participant I-15
Going back to management's perceptions. When you look at some of the opportunities that companies take, when they realize a large gain, to do these restructuring charges and write-off assets, it shows you that management is often shortsighted and unreliable. You can't believe what management tells you many times. [Also included in 4] **[TI 1/13, p. 18]**

Participant I-12
Going back to the question of why don't we just use market value? The market is nothing more than a value at a point in time. All the market is is collective judgments as to the fair market value at a point in time. I'm saying that those judgments have a lot of unreliability in them. Is [name deleted] really worth $8.50, the price it closed at at the end of 1991, or is it

worth $21.50? Those differing prices simply reflect the collective decision-making of analysts. I'm not convinced that that's an appropriate benchmark that gives us the kind of reliability and stability that we need to make our own judgments about what the market might do. We're getting into some circular logic here that bothers me a lot. [Also included in 4] **[TI 1/13, p. 18]**

Committee/Staff/Observer
Last question on fair value, which deals with the volatility or "noise" issue in reported earnings. First, do you agree that fair values in financial statements would introduce unhelpful noise in reported earnings? Anybody think it will not introduce unhelpful noise? The answer seems to be no. Next question: would your answer to this question differ depending on how the impact of fair value measurements is reported in the income statement? [Also included in 4] **[TI 1/13, p. 22-23]**

Participant I-7
And reliable? [Also included in 4] **[TI 1/13, p. 23]**

Committee/Staff/Observer
Take the reliability issue off the table. [Also included in 4] **[TI 1/13, p. 23]**

Participant I-11
I don't think you can separate those issues. My complaint is this notional fair value is fundamentally an unreliable number. What is the fair value of the [large commercial office building]? [Also included in 4] **[TI 1/13, p. 23]**

Participant I-8
If I am not mistaken, there is already a distinction made in the income statement in the way in which accounting is done for earnings of foreign companies depending on whether the currency is considered to be stable or the "banana republic" type thing. The accounting profession is saying that in the latter case, the accounting will be done a specific way because the currency fluctuations should stay within a specific band. [Also included in 4] **[TI 1/13, p. 23]**

Committee/Staff/Observer
There is no interest for running value changes through the income statement. I'm wondering what your reaction is to the accounting in the pension arena when value changes are in effect spread to eliminate volatility. That's kind of a compromise in the market value arena; is that good or bad? [Also included in 4 and 9] **[TI 1/13, p. 23]**

Participant I-7
You're not in the business of putting businesses out of business. In some instances, if you didn't spread, you would really create a problem. [Also included in 4] **[TI 1/13, p. 23]**

Participant I-8
I think it's good; it reflects the realities of the world and to that extent it's good. The real question is whether the actuarial assumptions are valid or not, not the interim fluctuations in the assets that happen to be held at that moment. [Also included in 4 and 9] **[TI 1/13, p. 24]**

Participant I-12
I have a problem with the actuarial assumptions. We all know of companies that are still using 7-10% accumulation rates. This comes back to the notion of reliability. I don't have a problem in trying to reflect in some manner the cost of employee health care benefits; on the other hand, what happens if we socialize medicine and get deflation? [Also included in 4 and 9] **[TI 1/13, p. 24]**

Participant I-5
The question of reliability is fine and good, but the fact is the present historical book value that is recorded is significantly less reliable than someone's best guess of fair value today in 95% of the cases. For example, [name deleted] gets an appraisal every year; $1.8 billion 4 years ago, then $1.7 billion, then $1.6 billion. Meanwhile, the bond is trading as if it's worth maybe $700 million. If the company shows it in the balance sheet at historical cost of $600 million and didn't tell you about the $1.8, $1.7, and $1.6 billion, what is the best measure? I think the best guess of what someone says it's worth today is valuable to have relative to what the cost was in 1936. [Also included in 4] **[TI 1/13, p. 24]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of disclosure about operating opportunities and risks. During the discussion, an investor answered a question on reliability.

Committee/Staff/Observer
Before you answer that, the next question we have is right on that point. The second framework that we talk about in the materials is the SEC's MD&A requirements. In MD&A, the discussion and analysis of results of operations is to focus on events and uncertainties known to management that would cause the reported information to not be a good indicator of future operating results. It is also to describe known trends or uncertainties that have had or that management expects will have a material impact on net sales or revenues or income from continuing operations. Our question is: do those MD&A requirements provide a workable framework for categorizing and disclosing what you need to know about operating opportunities and risks? Is it a promising starting point or basis from which to develop an accounting standard requiring disclosure of information about operating opportunities and risks? And there is also [committee/staff/observer]'s question; do you believe what you get? [Also included in 10(b) and 13] **[TI 1/13, p. 48]**

Participant I-7
Reliability is in the mind of the issuer. I think it goes beyond reliability. There are certain managements that are "ept" and others that are inept. So when you read the MD&A or have a discussion with management, for the most part, they're trying to give you as reliable information as they possibly can. But within the context of a competitive environment, some are being inept. [Also included in 10(b) and 13] **[TI 1/13, p. 48]**

For example, management thinks the company is going to have a 10% sales increase this year in the motor industry; 6% increase in units and 4% increase in sales price. The statement is

absolutely true until you go out into the marketplace and find that 25% of the business is distributor-related; so the distributor will also increase its price by 4%, but salesmen of the 75% segment of the business will be under pressure to get the price increase down to as close as 1% as possible. So 10% is going to be wrong if you're setting up your cost structure on that basis. [Also included in 10(b) and 13] **[TI 1/13, p. 49]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of auditor involvement. During the discussion on the scope of auditing, an investor made a comment about reliability of information.

Participant I-12
The MD&A may also be an area that would be more appropriately handled by the SEC, in terms of what kinds of things belong there. I agree with the notion of having an independent opinion of internal control and information systems because that leads back to the reliability of the information that we're getting. Also, the auditor could play a role in the MD&A in terms of bringing out environmental changes and the company's exposure to those changes. And perhaps greater discussion of assumptions that underlie all the numbers. [Also included in 9 and 17(b)] **[TI 3/17, p. 10]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality.

Committee/Staff/Observer
Question 8 wraps up our discussion of auditor involvement and relates to the concept of conservatism. Let me address the question in parts. Parts (a) and (b) talk about attributing a higher quality of earnings and a better multiple if a company uses conservative accounting practices. First question: is accounting conservatism widely used in financial analysis as a key factor in assessing the quality of earnings of a company? **[TI 3/17, p. 29]**

Participant I-12
I think there's a lot of lip service applied to quality of earnings. I heard analysts tell me that the [name deleted] had very conservative accounting principles 6 months before they blew up. As analysts, we have a spiritual search for high quality earnings and, in many respects, we use that to justify a position to buy or sell a stock when that may or may not be the reality. I have a problem with this issue of quality of earnings. **[TI 3/17, p. 29]**

Committee/Staff/Observer
On page 9 of the meeting materials, we give 5 items that describe conservatism.
[1. Conservatism means to anticipate no profits but anticipate all losses
2. Conservatism means providing for losses when profits are high so that a company's resistance to recording losses in low-profit periods will not result in overstated assets or understated liabilities

3. Convservatism offsets the natural over-optimism of managers who tend to view the expected operations of their company through rose-colored glasses
4. Conservatism makes it likely that possible errors in measurement will be in the direction of understatement rather than overstatement of net income and net assets and thus future surprises are likely to be pleasant
5. Conservatism means that the uncertainties that inevitably surround many transactions should be recognized by exercising prudence in preparing financial statements but does not justify creation of secret or hidden reserves.]

Which one(s) fits your definition? **[TI 3/17, p. 29]**

Participant I-16
The one I prefer is 5. However, what financial analysts really like is a company where you can take a straight edge and describe the trend in earnings. That is one problem I have with conservatism; it sounds like a nice thing but the more conservative you are, the more leeway you have to manipulate the trend. I'm always wary when accountants are putting in a change in accounting principles that appears to be more conservative because my suspicion is that there might be more room to manipulate the trend. **[TI 3/17, p. 29]**

Participant I-11
I agree. **[TI 3/17, p. 29]**

Committee/Staff/Observer
Still on conservatism, question (d) talks about chosing between two concepts: conservatism and neutrality. We note that conservatism conflicts with reliability and neutrality which are two key qualities that make financial information useful. Financial reporting cannot be reliable and neutral and at the same time conservative. Our question is: do you accept that reliability and neutrality are more important qualities than conservatism? Or do you think that accounting should emphasize conservatism to avoid reporting values that may not be realized even if their realization is likely? **[TI 3/17, p. 30]**

Participant I-11
As long as you're dealing with estimates, I'm not sure that there is such a thing as neutrality. It's a principle that I think is good but, in fact, you're making judgements in making those estimates and they are subjective and you can't be neutral. The auditor's responsibility lies in making his professional judgement about those estimates; probability and magnitude are things that enter into that judgement and each one has to be dealt with in light of the particular circumstances. My bias is that if you have to err, err on the side of conservatism because it does less harm. **[TI 3/17, p. 30]**

Committee/Staff/Observer
[Participant I-11], if everybody agrees that a certain outcome is most likely, it's the best guess, but there is a more conservative outcome that is at least reasonably possible but not the best guess, you're not advocating going to the most conservative guess? **[TI 3/17, p. 30]**

Participant I-11
No, the best guess and I want the auditor to tell me what the best guess is without bias whether it's conservative or liberal. But if it's 50/50, then let's go with the conservative. [Also included in 17(c)] **[TI 3/17, p. 30]**

Participant I-7
Reliability and neutrality are the most important qualities for me, much more important than conservatism. **[TI 3/17, p. 30]**

Participant I-16
Our job is to put a value on an enterprise, not to make sure that a company won't go out of business; that's not what investors are trying to do. Conservatism is putting a floor estimate on the company's earnings, cash flows, and value. It's highly unlikely that the true value is below that number. For most purposes, that would not be a useful number because most people using financial statements are not trying to come up with a floor number. Most of us are trying to get to a realistic estimate of value and efficient capital markets require that. [Also included in 1(a)] **[TI 3/17, p. 31]**

Participant I-12
There has to be a balance between the two. I don't want a company ignoring reality in the interest of conservatism. We have all seen companies that are having terrific results through reasonably generated numbers, not flaky accounting, and the CFO decides that rather than growing 20% this year, they'll grow 16%, and sock earnings away in reserves for future years. As analysts, we will go back and make adjustments if we know that this is happening. Similarly, if things are horrible, I want to know they're horrible. There has to be a balance between the two principles and I can't say that I prefer one over the other. [Also included in 1(c)] **[TI 3/17, p. 31]**

Participant I-16
One example of the use of conservatism is the extent to which a company writes down physical or intangible assets or recognizes expenses that will really benefit future periods. Companies get away quite often because it's viewed as conservative but I would like to see when that happens the auditors give some recognition of the fact that the company is boosting its future reported earnings. I can recall a company that acquired a business from another company and did not acquire the brand name; as a result, as part of the cost of the acquisition, they wrote off the next two years of advertising. They said that they were being conservative in writing down the value of what they had acquired, but what happens after two years when you have to start expensing for advertising? Is that really conservative? [Also included in 17(c)] **[TI 3/17, p. 31]**

Committee/Staff/Observer
Page 10(e) of the meeting materials presents two statements that summarize what we said about conservatism.

[• Conservatism should not connote deliberate understatement of assets or overstatement of liabilities. Nor should financial reporting attempt consistent understatement of income, which in any event is impossible to achieve because decreasing income of one period inevitably increases income of a later period or periods.

- Conservatism is a prudent reaction to uncertainty to try to insure that uncertainties and risks inherent in business situations are adequately considered. For example, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism suggests using the less optimistic estimate. However, if two amounts are not equally likely, conservatism does not dictate using the more pessimistic amount rather than the more likely one. Neither does it require deferring recognition of income beyond the time that adequate evidence of its existence becomes available nor justify recognizing losses before there is adequate evidence that they have been incurred.]

Do you agree with the two paragraphs? If not, why? **[TI 3/17, p. 31]**

Participant I-11
I agree; those two bullet points put it very well. **[TI 3/17, p. 32]**

Participant I-12
Yes. **[TI 3/17, p. 32]**

Participants I-7 and I-16
Yes. **[TI 3/17, p. 32]**

Committee/Staff/Observer
Question 9 deals with volatility of earnings and the question is in parts. Parts (a) and (b) say that it is our understanding that investors attribute a higher quality of earnings and a better multiple if a company's earnings shows a stable trend and a lower quality of earnings and multiple if it shows variability and volatility. Our first question related to volatility is: do we have a reasonable understanding of the way stability, variability, or volatility affect the quality of earnings in financial analysis? Further, is stability, variability, or volatility of earnings widely used in financial analysis as a key factor in assessing the quality of earnings of companies? **[TI 3/17, p. 32]**

Participant I-12
I'd like to start with the second part first. Yes, it's widely used; we all look at the variability of earnings. There are cyclical and secular factors; I'm not convinced that higher and lower multiples necessarily are attributed to companies with more stable earnings. If you analyze multiples across the S&P 500, the highest multiples are on the companies with the worst earnings, and it's purely a mathematical exercise. At a cyclical bottom, the multiple on [name deleted] earnings is going to be much higher than it is at a cyclical peak, and that's just because there is no earnings. The market is anticipating future earnings and is assigning a normalized multiple to those earnings. As analysts, we would tend to attribute a more stable multiple. The range of multiples assigned to a [one company] will be vastly different from a range of multiples assigned to [other companies]. So variability of earnings is something we look at a lot and it is important to us. **[TI 3/17, p. 32-33]**

Participant I-16
Clearly, one pays a premium for stability because it is presumed to be an indicator of lower future risk and uncertainty, thus, it should get a higher valuation. I think the market has gotten a little more sophisticated in viewing stability and the evidence for that would be the low multiples for more diversified businesses versus less diversified businesses; in the latter,

you can understand whether reported volatility is reality much more easily in a one-product business or one-industry business, like [name deleted], than would be the case with a highly diversified company. A lot of large diversified companies have broken up, cognizant of the fact that the market penalizes companies if you can't understand how that trend comes about. Just showing a nice trend that investors don't believe represents reality will not provide a value as high as about 10 years ago. **[TI 3/17, p. 33]**

Committee/Staff/Observer
The last question about volatility is: what problems related to volatility do you have with the information you receive from external financial reporting? The meeting materials on page 11 identified 4 possibilities. [Also included in 4] **[TI 3/17, p. 33]**

Participant I-12
Fair value accounting. Running changes in the value of a bond portfolio through the income statement is going to make that statement incredibly volatile, and it may be a faked volatility because those quarterly gains or losses may or may not be realized. For example, anybody who sold their stocks November 1, 1987 probably realized substantial losses; anybody who waited 6 months probably made out just fine. So the realization of gains and losses is vastly different from the paper effect. Fair value accounting would just make the volatility of earnings that much worse. [Also included in 4] **[TI 3/17, p. 33]**

Participant I-16
Does that make it worse or does that just recognize the reality? [Also included in 4] **[TI 3/17, p. 33]**

Participant I-12
What's reality? [Also included in 4] **[TI 3/17, p. 34]**

Committee/Staff/Observer
I don't want to get into an argument but I could argue that the November 1 person holding the securities as opposed to the person who sold those securities is not presenting a very correct balance sheet. I'm not talking about how to handle that in the income statement, that's a different issue. [Also included in 4] **[TI 3/17, p. 34]**

Participant I-12
But in terms of volatility, that would introduce volatility in the income statement that wasn't there before. [Also included in 4] **[TI 3/17, p. 34]**

Committee/Staff/Observer
Assuming you put the unrealized November 1 loss in the income statement. [Also included in 4] **[TI 3/17, p. 34]**

Participant I-7
For me, earnings volatility has nothing to do with earnings quality for the companies I follow. In terms of measuring quality, if I know that the company is following good accounting procedures, earnings volatility has nothing to do with earnings quality. **[TI 3/17, p. 34]**

Committee/Staff/Observer
We've talked about the quality of earnings; how would you define quality earnings? We've talked about the concept of core earnings, which I would define as the earnings to which a multiple greater than one is applied. Can any analogy be drawn between core earnings and quality earnings? Could I think about quality earnings in terms of a multiple? Are good quality earnings earnings that you apply a multiple greater than one to, lower quality earnings something you apply a multiple of one to? [Also included in 5(a)] **[TI 3/17, p. 34]**

Participant I-16
There are two ways of looking at it. One is the conservatism aspect; for example, companies using accelerated depreciation using the same useful lives as another company using straight-line, are clearly more conservative and are perceived as having better quality of earnings. The second aspect is predictability and stability. If you believe a company can report earnings of at least that much in the next year, it's worth more than if you have no idea. For example, if I had the earnings of [name deleted] for one year and ask how much it's worh, I wouldn't have any idea because I don't know whether they made any money in the prior year and whether they would make any money in subsequent years. [Also included in 5(a)] **[TI 3/17, p. 34-35]**

Participant I-7
One of the problems I have in answering that question is that earnings quality is only one aspect entering into the valuation of a company. For me, earnings quality is only one measurement of valuation. [Also included in 5(a)] **[TI 3/17, p. 35]**

Participant I-12
I would focus on the concept of earnings quality equals predictability. For example, [name deleted] is considered among the highest quality in the brokerage business, a highly volatile business. The company typically gets a substantial discount to the S&P multiple because they have a merchant banking operation where they periodically take gains. You take those numbers out and then look at the P/E and it gives you an entirely different perspective, because the market is looking at the predictable elements. I think of core earnings as operating earnings; the merchant banking part is not an operating business. What I assign a multiple to is the portion of the earnings where I have some ability to predict them. [Also included in 5(a)] **[TI 3/17, p. 35]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of databases. During the discussion, comments were made on the reliability of information provided by databases.

Participant I-16
I have spent most of my career as a generalist, which means that I have been working on companies that I haven't worked on for very long, so I don't have a database or history. So I use a database as a way to allocate my time. You can screen, using 10 years of financial statement numbers, an enormous number of companies in a couple of minutes, perhaps pop out some anomalies that are worth investigating. I wouldn't buy a stock based upon a screen because I don't know if there is enough reliability. But if it can limit the universe and enrich

the likelihood of finding something good in that universe, then it's a very useful screening device. I know there are some firms that use databases to make investments, but I think most of us use them for screening purposes. It helps narrowing down my search. [Also included in 1(c) and 16(a)] **[TI 3/17, p. 48-49]**

Committee/Staff/Observer
How do you know what's in databases is accurate or complete? [Also included in 16(a)] **[TI 3/17, p. 49]**

Participant I-7
You don't. [Also included in 16(a)] **[TI 3/17, p. 49]**

Participant I-12
Until you check it against the financial statements. If a database shows the assets of a company at $10 billion and the financial statements show total assets at $15 billion, it makes you wonder about the database. [Also included in 16(a)] **[TI 3/17, p. 49]**

Participant I-5
Unfortunately, a lot of them [database vendors] adjust [information] in different ways. You're not certain exactly how a database treats different items. As an analyst, it takes long enough to look at a company's financial statements for the year as they're presented; to take them as they are somehow massaged in a database, it does not help you much to get an opinion on a company. Where I found databases useful is in getting aggregate numbers; for example, the median cash flow coverage ratio for all single B credits. You can get that from a database without being that far off. [Also included in 1(c) and 16(a)] **[TI 3/17, p. 50]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-17
One of the difficulty with fair market values is they're so volatile. I that as additional information, it's helpful, because it gives you a reference point. Knowing what the spread is and getting some sense of fair market versus historical is important. I don't base my decisions solely on it. The thought that comes to me is sometimes, if I'm trying to choose between a secured and unsecured debt, for example, I may want to factor in how much capital support is really there. And I may be swayed to some extent by the reliability of the values that I see. You use fair values with a certain amount of prudence. [Also included in 4] **[TC 2/2, p. 3]**

Participant C-13
The historical cost model seems to suit our requirements the best. But fair value information, providing you can satisfy yourself as to reliability, is important, particularly if there's a large disparity between fair and book value. The [name deleted] example is a good one on one side. The life insurance industry in the 1980's is a good example on the other side, where the much

lower market values book indicated some pressures and strains on the industry. [Also included in 4] **[TC 2/2, p. 5]**

Participant C-7
I guess we rely on historical cost because of consistency and the relative objectivity. I think fair value becomes an issue whenever you think that there's a variance; the degree of variance somehow correlates to your interest in fair values. It's when you see a major variance that you become interested. You want to abandon the historical cost concept, and then get into current value. [Also included in 4] **[TC 2/2, p. 7]**

Participant C-11
I would agree with all of these comments. I think that if we're talking about going concerns, the need for fair value information and its reliability and usefulness, in terms of knowing how well the business is doing, is lot less and definitely that puts it into supplemental status. I think we have a great problem in general as to knowing when a company is in distress, and when we have to take a different accounting approach. So far, all the comments have been focused on revaluing at market values specific types of assets. Nobody's mentioned liabilities. But I think we can't forget that. I want to make a comment that in an increasingly distressed situation, a company doesn't have to, necessarily, sell one particular type of loan or securities or whatever. There is often an option of selling part of its business. And so when you're talking about what is the fair or market value of an entity, it isn't necessarily just individual assets. It can be a business component. And the way you value the component of the company's business is going to be a lot different then. And it may be even more successful a way to take care of a distress situation than just selling its individual loans. I think if you're thinking about market value, you have to think in a more complex way and not just value the specific individual assets and liabilities and think you've done the job. I feel strongly about that. I'd also make just a general comment about supplemental information. I don't ascribe more importance to something because it's in a footnote, as opposed to being in a supplemental schedule of some sort. We have all kinds of supplemental schedules that are required and that's where you can get some of your best data. As a user, I don't have a phobia about needing to have it on the balance sheet or a footnote, per se. [Also included in 2(a), 4, and 5(d)] **[TC 2/2, p. 7-8]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality.

Committee/Staff/Observer
Question 9 deals with conservatism, neutrality, reliability and volatility. The fundamental question is whether or not conservatism is something you seek or not seek in financial statements and how do you define conservatism for purposes of the analysis work you do? **[TC 3/11, p. 39]**

Participant C-5
I am probably even a minority in my own institution in saying that conservatism is a bane for me in terms of that whole approach, whether it's financial statements or just an approach to doing business. It is frustrating because I don't know the degree of conservatism or the degree of bias that's inherent in the financial statements. Things like inventory accounting methods where conservative inventory treatment is aggressive income statement treatment and vice versa. As far as neutrality, that's assumed and I haven't seen accounts that have been other than neutral. Volatility, there is absolutely nothing in the financial statements that lets me understand the volatility of the reported numbers. For example, I can have a company holding a rental property where loss of a key tenant representing 78% of the rental could change the whole value assumption whereas one that's a tenant at will that looks like it has no long term leases but they've been in there for 30 years, the building has got a real continuity to its value. It is important to understand what is the value but also to put the context around it to allow me to understand how volatile those assumptions are. **[TC 3/11, p. 39]**

Participant C-13
I think it's important to recognize conceptually that the investor in securities is confronted with an array of securities which he may buy, hold or sell or decline to buy. And if through some misperception of conservatism, either in the presentation and valuation or in some kind of smoothing of earning sense, the investor doesn't get a true picture of what the company operations are, then the financial statements haven't fulfilled their obligation. My definition of conservatism would be much closer to number five here in your list (in the premeeting materials). **[TC 3/11, p. 39]**

Committee/Staff/Observer
With respect to number five would you seek that level of conservatism or does that frustrate you? **[TC 3/11, p. 40]**

Participant C-13
No, that level of conservatism is not necessarily frustrating. I think that's clearly the closest definition that you've got here for conservatism and I would very vigorously reject number two, for instance. **[TC 3/11, p. 40]**

Participant C-17
The operative words for me are really reliability and volatility. I want to know that the information is reliable. And the other part of it is when you see statements that show a great deal of volatility, I tend not to trust them. **[TC 3/11, p. 40]**

Participant C-13
Well then the reality is volatile. **[TC 3/11, p. 40]**

Participant C-17
Well, if the reality is volatile, then I tend not to trust management. **[TC 3/11, p. 40]**

Participant C-13
You trust the business, though? **[TC 3/11, p. 40]**

Participant C-17
I'm talking about sudden and dramatic changes in asset accounts or extraordinary write ups that occur from out of the blue or extremely complex footnotes that would take Solomon and twelve others to try to understand what it is they're really talking about because probably nobody really knows. **[TC 3/11, p. 40]**

Participant C-12
I like the C-4 definition which isn't real conservative. But it's been my experience that very strong companies tend to be this sort of conservative in reporting results and that less strong companies tend to be a little more aggressive, to push a little harder to keep up with the very strong companies. **[TC 3/11, p. 40-41]**

Committee/Staff/Observer
But of the choices, you'd prefer four? **[TC 3/11, p. 41]**

Participant C-12
Yes, I like four. **[TC 3/11, p. 41]**

Participant C-1
The way you phrased the question, it's an equity question. Because for me, a lot of the write-offs and reserves that are done are more to justify a bad year; let's dump everything we possibly can into it so that our earnings on a net income basis will improve next year whereas from my standpoint cash flow is more important. So I've got to go back and adjust for these reserves that were set up in 1992 for plant closings that are not going to happen till 1993. The other part is that conservatism relates to this concept of hidden assets on the balance sheet where you've got inventories and receivables that are based on cost and maybe should be also based a little bit more on market. Market value might be lower but, at the same time, the market value of fixed assets also based on cost could be dramatically higher. There's no way to really tell whether assets and/or liabilities have any type of reality to the true market value of the company. [Also included in 4] **[TC 3/11, p. 41]**

Committee/Staff/Observer
Let me ask you a follow up question with regard to inventory and receivables. If cash flow is the target, isn't there still a conservatism question, though, in terms of the valuation of inventory and receivables vis-a-vis the potential cash flow? And if so, how conservative an estimate of future cash flows do you want? **[TC 3/11, p. 41]**

Participant C-1
I'd rather have assets that you anticipate in some way liquidated over a short period of time, one year, to be extremely conservative. And I don't mean being hidden but I think that there are assets which are not truly short term assets that are put in that section. [Also included in 5(b)] **[TC 3/11, p. 42]**

Participant C-4
From a creditor's standpoint, conservatism is something that we would always like to see. Quite often, management will come to us and say that their numbers are conservatively stated. We will be much more liberal in applying our underwriting standards to a company that did

consistently conservative reporting. Probably leaning towards number four here as far as our overall feelings about conservatism. **[TC 3/11, p. 42]**

Participant C-11
I basically don't like the word conservative at all because it could be misinterpreted in the way that others have just spoken of in terms of "if there's any question make it a very low number and end up having undervalued assets and ineffective reserves". The word realistic or relevant to the situation is more appropriate. And consistency also is important. Consistency of application so that you don't get what I would call artificial, arbitrary swings in numbers because, in this case, they've been valued too low and then something transpired and they had to be written back up or whatever. [Also included in 2(c)] **[TC 3/11, p. 42]**

Committee/Staff/Observer
Let me give you an example that was given to me so I can test your feel for conservatism. Real estate market in Europe is apparently weakening. Realistically, perhaps the collateral is salable now at the value of the loans on the books. However, conservatism might tell you that you believe that the trend will be down. So a very conservative approach would be to project what the real estate market will be three years hence and write the loans that are collateralized down to that level now. Is that appropriate use of conservatism? [Also included in 4] **[TC 3/11, p. 42]**

Participant C-17
No, the move to write the banks' assets down on their performing assets to collateral value would be pretty strenuously objected to. Conservatism may create some real hardships in terms of their ability to lend or their willingness to lend. To just simply do it because it appears to be the most conservative approach is not a good idea. [Also included in 4] **[TC 3/11, p. 42-43]**

Participant C-5
Reasonableness or neutrality would suggest that the auditor has to review the likely ability to hold the asset through this cycle. U.S. financial institutions just showed record profits in 1992 of $32 billion. They also showed losses in 1991 and maybe, in fact, that they didn't have either one of the two but their concept of conservatism has both made banks look tremendous in 1992 and totally abominable in 1991. So conservatism is really showing its true colors in that kind of scenario. The banks are not that much better than they were and they weren't as bad. **[TC 3/11, p. 43]**

Participant C-1
Just in terms of the inventory, I would just take out of current assets anything that the banks wouldn't lend against. Because then it's not current. [Also included in 5(b)] **[TC 3/11, p. 43]**

Participant C-17
But that's not always the case. If I'm sitting as a secured lender to the inventory, I'm looking at it in terms of what's it going to bring to me if it liquidates. So a lot of times, a lender's going to advance against his perception of liquidation value, not the normal operating cycle. [Also included in 5(b)] **[TC 3/11, p. 43]**

Participant C-12
I think one of the problems with bank lending on real estate generally is for the first year, maybe even two years into the process, everybody's reasonable estimate of the value of the collateral, even most people's worst case, isn't bad enough. But a number of U.S. banks today have levels of reserves which are at or above the level of problem loans. **[TC 3/11, p. 43]**

Committee/Staff/Observer
The next question is: when companies are doing well, should accounting encourage them to put away larger reserves so that when things aren't going so well, they have those to fall back on or should the lean years and the fat years essentially stand on their own? **[TC 3/11, p. 43-44]**

Participant C-14
I think most of us are going to say no to accounting smoothing earnings and I would say that net worth is your reserves for cyclical or seasonal peaks. **[TC 3/11, p. 44]**

Participant C-11
If a company's business has swings in it due to sales or unexpected cost changes, those kinds of things are very important to show in the financial statements. On questions of reserving, if you're a financial institution and you're making loans, by definition they're risky. There is a loss content in the aggregate in all lending. So rather than just letting it all hang out there should be a recognition of loss content in loans at the time that the loans are made and you're getting income relating to that. **[TC 3/11, p. 44]**

Participant C-5
I would not agree that accounting should smooth the volatility in earnings but I also would suggest it should not exaggerate the volatility and it has to understand the company's movements and activities throughout these cycles that exist. I repeat the bank example; they exaggerated the volatility that has occurred over the last two years in the reporting of the financial information. The statement that higher quality earnings were attributable to consistency, that's true. An investor, a creditor is very comfortable with a stable source of period earnings or a steady trend line of earnings. If a company is in a less cyclical business, it is able to operate with lower leverage. It is able to operate with lower multiples of coverage and so forth and that's just the advantage of that business. But cyclical companies have to make a lot of money in the good times because of that and investors accept that. So I'm not troubled by the fact of volatility or lack of volatility as a reflection of quality of earnings. That's understood and the risk factors that go into it are there and the capital bases required to deal with that are appropriate. **[TC 3/11, p. 44]**

Participant C-13
I agree with that. But [participant C-5], with all due respect to your former life, it was the regulators not the accountants who caused the volatility. **[TC 3/11, p. 45]**

Committee/Staff/Observer
[Participant C-13], let me ask a question. [Participant C-5] says that there's more comfort, and I presume that means that there's better credit given, to stable earnings. Doesn't that tend

to push companies then to do what they can to smooth earnings, to see if they can achieve a lower cost of capital? And if so, is that a bad thing? **[TC 3/11, p. 45]**

Participant C-13
I agree that stable results would tend to lower cost of capital. And that therefore there is an incentive to try and report stable results in order to lower your cost of capital. So the tendency is always in that direction. Investors have to be appraised of the true volatility in order to make correct credit judgments in allocating capital. So it's important that the financial statements reflect the underlying reality, getting back to the word that [participant C-11] used earlier. **[TC 3/11, p. 45]**

Participant C-17
I'd rather see real reserves for real expected expenses. I think it's something of a conflict because the other part is that the market does reward stable earnings. What you see happen a lot is the attempt to keep stable earnings. But when there's nothing more to lose because you're going to have "a bad year anyway", that's when an asset suddenly gets written off. That's when those issues are faced. **[TC 3/11, p. 45]**

Participant C-12
In general I don't want the accounting to prove the quality of earnings. On the other hand, looking at something like bank lending on real estate, maybe we should recognize that that is a cyclical business, that the value of the collateral the banks are lending on is cyclical and that the higher the cycle and the longer the up part goes, the deeper the trough is going to be and maybe that should be factored into earnings each year. Because it would be hard to argue that the banks didn't, in effect, open the port to earnings in the late eighties. **[TC 3/11, p. 45-46]**

Participant C-5
I don't disagree. It exaggerated both ways. It exaggerated the boom and it exaggerated the bust. So the accounting which thought it was being conservative actually didn't help either way. **[TC 3/11, p. 46]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of the impact of litigation on auditing and external reporting. During the discussion, a comment was made on qualitative aspects of external reporting.

Participant C-5
I realize the dilemma in what we get in that it [litigation] does constrain. I know from the other side of the fence that it constrains us in the way of disclosures for both management and then the accountants. And it gets back to conservatism; you're unlikely to be sued for being conservative. I think in any attempt to remove this, what you need to do is increase the disclosure, not of the actual financials but the disclosure of the work that's been conducted. There's still a lot of flexibility on the part of individual firms to make their own determinations. In our environment, the potential for us to suggest a CPA change is almost nonexistent. [Also included in 18(b)] **[TC 3/11, p. 62]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 9

a. Indicate your degree of agreement or disagreement with the following descriptions of conservatism:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
1. Conservatism means to anticipate no profits but anticipate all losses.	*1*		*1*	*2*	*1*
2. Conservatism means providing for losses when profits are high so that a company's resistance to recording losses in low-profit periods will not result in overstated assets or understated liabilities.				*3*	*2*
3. Conservatism offsets the natural over-optimism of managers who tend to view the expected operations of their company through rose-colored glasses.		*2*	*2*	*1*	
4. Conservatism makes it likely that possible errors in measurement will be in the direction of understatement rather than overstatement of net income and net assets, and thus future surprises are likely to be pleasant.	*1*	*2*	*1*	*1*	

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
5. Conservatism means that the uncertainties that inevitably surround many transactions should be recognized by exercising prudence in preparing financial statements but does not justify creation of secret or hidden reserves.	*4*	*1*			
6. Conservatism should result in using the less optimistic estimate if two estimates of amounts to be received or paid in the future are about equally likely.	*2*	*1*	*1*	*1*	
7. Conservatism should not dictate using the more pessimistic amount rather than the more likely one if two amounts to be received or paid in the future are not equally likely.	*2*	*3*			
8. Conservatism should not require deferring recognition of income beyond the time that adequate evidence of its existence becomes available nor justify recognizing losses before there is adequate evidence that they have been incurred and can be reasonably estimated.	*2*	*2*		*1*	
9. Something else. Please describe: *Participant I-16:* Awareness of uncertainty which is more likely to be unfavorabe that favorable, management optimism which may bias estimates and the fact that the impact of unfavorable developments may be greater than that of favorable developments. Be aware of tendency to assume favorable resolution of unknowns.					

b. **Please indicate your degree of agreement or disagreement with each of the following statements about the proper role of conservatism in financial accounting and reporting by inserting the appropriate letter(s) in the blank.**

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
1. A company's use of conservative accounting is so important to the quality of its earnings that conservatism should *take precedence* over relevance, reliability, and neutrality in financial reporting.				*3*	*2*
2. *Consistent use* of conservative accounting procedures is desirable because while it generally does not decrease *total* reported income -- accounting procedures that decrease income of one period almost inevitably increase income of a later period or periods -- it shifts income to later periods and shifts losses to earlier periods.		*1*	*2*	*2*	
3. Accounting should avoid reporting values that may not be realized, even if their realization is likely, because a cushion of unrecognized gains provides a *needed margin of safety*.		*1*	*1*	*3*	
4. Credibility of accounting information rests on its reliability and neutrality--users can depend on it to represent faithfully the economic things or events that it purports to represent without bias intended to attain a predetermined result or to induce a particular mode of behavior--with which conservatism tends to conflict.	*4*	*1*			
5. Conservative accounting favors buyers of securities over sellers by suppressing good news while revealing or anticipating bad news.			*1*	*4*	

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
6. Evolution of conservatism from deliberate understatement of assets or overstatement of liabilities to a prudent reaction to uncertainty to try to insure that uncertainties and risks inherent in business situations are adequately considered should continue.		*3*	*2*		

Participant I-11: I think the issue here is one of degree. For instance, in #3, I would feel different about a large value with a 51% probability and a small (but still "material") value with a 99% probability. That, I suppose, is where appropriate reserve levels come into play.

[PMQI 3/17, p. 14-17]

QUESTION 10

Please indicate your degree of agreement or disagreement with the following statements about volatility of reported income by writing the appropriate letter(s) in each of the spaces below:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
a. Investors usually attribute a higher quality of earnings if a company's earnings or net income show a stable trend and attribute a lower quality of earnings if a company's earnings show variability or volatility.	*4*	*1*			
b. Stable earnings reduce the cost of capital.	*4*	*1*			
c. Companies that report significant swings in earnings are more difficult to analyze.	*3*	*1*		*1*	

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
d. Companies should be encouraged to use accounting methods that spread the effects of unusual transactions rather than create volatility in reported year-to-year earnings. *Participant I-9:* If they can properly do so. Otherwise, my answer is inconsistent with "f"		*2*	*2*		*1*
e. Companies should be encouraged to dampen reported volatility by increasing reserves in periods of high earnings and reducing those reserves in periods of low earnings.			*1*	*1*	*3*
f. Companies whose businesses are volatile should faithfully report that volatility. That is, they should not smooth earnings to appear less volatile than the underlying business..	*3*	*2*			

[PMQI 3/17, p. 17-18]

QUESTION 11

Please answer the following regarding *volatility*. For each item, please indicate whether the described accounting 1) is a *significant problem* to users of financial information, and 2) whether the problem, if any, can be solved through a) *expanded disclosure* alerting users to the degree to which the chosen accounting fluctuates in response to economic events or b) *standards changes* that eliminate the problem, if any, imposed by the accounting.

	Problem		*Solution*	
	YES	*NO*	*DISCLO-SURE*	*STANDARDS CHANGE*
a. Accounting procedures - such as for changes in foreign exchange rates, oil & gas activities, pensions benefits, and futures contracts - make earnings appear *more volatile* and companies appear *more risky* than they probably are.	*4*		*3*	

	Problem		*Solution*	
	YES	*NO*	*DISCLO-SURE*	*STANDARDS CHANGE*
b. "Historical cost" accounting procedures - such as those that ignore prices of assets unless they are bought or sold or those charging equal amounts of expenses to each period by systematic allocations - make earnings *more stable* and companies appear *less risky* than they probably are.	*3*	*2*	*3*	
c. Accounting procedures that recognize transactions and other events as they occur - such as accounting for changes in foreign exchange rates, pensions and other postretirement benefits, and investments in marketable equity securities - often are corrupted by provisions that *smooth reported earnings*, such as those that either spread the effects of price changes over several periods or allow the resulting gains and losses to bypass reported earnings or net income.	*3*	*2*	*2*	*1*
d. Accounting procedures - such as creating reserves that do not represent liabilities and capitalizing costs that do not represent assets or represent questionable or doubtful assets - permit companies to *manipulate reported earnings* by shifting costs and revenues between periods to create an illusion of consistency, leading many investors and creditors to underestimate the riskiness of the company.	*5*		*5*	*1*

COMMENTS

Participant I-16: Companies take charges as "one time" events while taking favorable adjustments as part of "on-going operations." The problem is both with standards and disclosure. Investors reward companies for stable earnings trends, creating substantial incentives for distortion.

Participant I-11: I don't think most of these are major issues, and I think that often the standards that have been enacted to deal with perceived abuses have created larger problems than they solved.

[PMQI 3/17, p. 18-19]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 10

a. Indicate your agreement or disagreement with the following descriptions of conservatism:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

Participant C-5: I don't like conservatism.

SA-1,D-11,SD-1

___ 1. Conservatism means to anticipate no profits but anticipate all losses.

Participant C-11: (D) But some FASB opinions and auditors use this definition.

A-1,D-8,SD-4

___ 2. Conservatism means providing for losses when profits are high so that a company's resistance to recording losses in low-profit periods will not result in overstated assets or understated liabilities.

A-3,N-5,D-5

___ 3. Conservatism offsets the natural over-optimism of managers who tend to view the expected operations of their company through rose-colored glasses.

SA-1,A-10,N-2

___ 4. Conservatism makes it likely that possible errors in measurement will be in the direction of understatement rather than overstatement of net income and net assets, and, thus, future surprises are likely to be pleasant.

SA-4,A-8,N-1

__ 5. Conservatism means that the uncertainties that inevitably surround many transactions should be recognized by exercising prudence in preparing financial statements but does not justify creation of secret or hidden reserves.

A-1

__ 6. Something Else.
Please Describe:

Participant C-4: Always error to the conservative side! Particularly when doing/using estimates.

Participant C-17: Conservatism means the firm carefully analyzes future trends and events and reserves at a level consistent with the probable future operating environment one to two years out.

b. Please indicate your agreement or disagreement with each of the following statements about the proper role of conservatism in financial accounting and reporting by inserting the appropriate letter(s) in the blank.

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

A-1,N-1,D-6,SD-5

__ 1. A company's use of conservative accounting is so important to the quality of its earnings that conservatism should *take precedence* over relevance, reliability, and neutrality in financial reporting.

A-6,N-2,D-5

__ 2. *Consistent use* of conservative accounting procedures is desirable because while it generally does not decrease *total* reported income -- accounting procedures that decrease income of one period almost inevitably increase income of a later period or periods -- it shifts income to later periods and shifts losses to earlier periods.

A-5,N-2,D-4,SD-2

__ 3. Accounting should avoid reporting values that may not be realized, even if their realization is likely, because a cushion of unrecognized gains provides a *needed margin of safety*.

Participant C-12: assuming "may not" means a 5-10% or more likelihood of the value not being realized, not a 0.5% or less probability.

Participant C-17: Rather because uncertainty always exist. No profit should be reported before its time. The probability and amount, however, should be revealed in discussion (MD&A) or footnotes.
[PMQC 3/11, p. 15-17]

QUESTION 11

Please indicate your agreement or disagreement with the following statements about volatility of reported income by writing the appropriate letter in each of the spaces below:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

SA-2,A-7,N-1,D-3
___ a. Creditors usually attribute a higher quality of earnings if a company's earnings or net income show a stable trend and attribute a lower quality of earnings if a company's earnings show variability or volatility.

Participant C-11: Quality is not good if the tend is stable, but the "real" underlying trend is variable.

Participant C-4: Could be cushioning earnings, hiding volatility, I want the facts.

SA-1,A-7,N-3,D-2
___ b. Stable earnings reduce the cost of capital.

Participant C-11: if the stability is for real.

Participant C-21: Stable earnings because industry and company are stable.

SA-1,A-9,N-2,D-1
___ c. Companies that report significant swings in earnings are more difficult to analyze.

Participant C-21: But if that is the nature of their business or industry and thus a risk that needs to be understood, not buried in an accounting treatment.

A-1,N-2,D-8,SD-2
___ d. Companies should be encouraged to use accounting methods that spread the effects of unusual transactions rather than create volatility in reported year-to-year earnings.

Participant C-9: Depends on transaction.

A-2,N-1,D-8,SD-2

___ e. Companies should be encouraged to dampen reported volatility by increasing reserves in periods of high earnings and reducing those reserves in periods of low earnings.

Participant C-11: If the reserves reflect underlying risk present - such as loan loss reserves.

Participant C-5: Unless high earnings create high risk, staff and cost buildup, lower quality loans, etc. I would argue that (high earnings) result from underreporting of risks, opportunity costs, etc.

SA-6,A-7

___ f. Companies whose businesses are volatile should faithfully report that volatility. That is, they should not smooth earnings to appear less volatile than the underlying business.

Participant C-14: Quality of earnings reflects degree of predictability. Even companies with volatile/variable earnings can have predictable earnings to the extent that the volatility is caused by cyclical/seasonal factors. Predictability is a reflection of management quality and results in lower cost of capital.
[PMQC 3/11, p. 17-18]

QUESTION 12

Please answer the following regarding *volatility*. For each item, please indicate whether the described accounting 1) is a *significant problem* to users of financial information, and 2) whether the problem, if any, can be solved through a) *expanded disclosure* alerting users to the degree to which the chosen accounting fluctuates in response to economic events or b) *standards changes* that eliminate the problem, if any, imposed by the accounting.

Problem? Solution?

Y - YES D - Disclosure
N - NO S - Standards Changes

Y-4,N-9 **D-3,D&S-1**

___ ___ a. Accounting procedures - such as for changes in foreign exchange rates, oil & gas activities, pensions benefits, and futures contracts - make earnings appear *more volatile* and companies appear *more risky* than they probably are.

Y-6,N-7 **D-5,S-1,D&S-1**

___ ___ b. "Historical cost" accounting procedures - such as those that ignore prices of assets unless they are bought or sold or those charging equal amounts of expenses to each period by systematic allocations - make earnings appear *more stable* and companies appear *less risky* than they probably are.

Y-7,N-5 **D-5,S-3**

___ ___ c. Accounting procedures that recognize transactions and other events as they occur - such as accounting for changes in foreign exchange rates, pensions and other postretirement benefits, and investments in marketable equity securities - often are corrupted by provisions that *smooth reported earnings*, such as those that either spread the effects of price changes over several periods or allow the resulting gains and losses to bypass reported earnings or net income.

Y-9,N-2 **D-6,S-1,D&S-1**

___ ___ d. Accounting procedures - such as creating reserves that do not represent liabilities and capitalizing costs that do not represent assets or represent questionable or doubtful assets - permit companies to *manipulate reported earnings* by shifting costs and revenues between periods to create an illusion of consistency, leading many investors and creditors to underestimate the riskiness of the company

COMMENTS:

Participant C-20: Under a. Sufficient disclosure already. Under c. These are good reasons for smoothing (e.g., actuarial gains and losses under pensions). Under d. Present GAAP does not permit questionable assets. This is an issue regarding the ethics of management.

Participant C-14: I am not sure that the way I am reading the question is as intended.

Participant C-11: Regarding c: Bad question. Too many different issues present. Regarding d: This doesn't sound like GAAP - I don't know what issues are here.

Participant C-9: D - This area can be a great unknown. Users may not have sufficient information to make an educated assessment. Standards may provide potential to window dress - couldn't that also lead to creditors overestimating the riskiness due to lack of supporting information?
[PMQC 3/11, p. 19-20]

[The CIC] oil industry subcommittees [complimented oil companies] regarding the quality and timeliness of information made available to investors and the awareness of most managements of their obligation to those who own the company. [However,] the Insurance Subcommittee, [commented]: "In general, comments from subcommittee members showed a growing frustration with the lack of candor and insight into the numerous problems of both the life and property-casualty industries provided by many insurance management teams. There is a sense that too many companies are not being managed in an effective manner. . . .It is hard to believe, but the quality of the industry's reporting to shareholders continues to deteriorate." [Also included in 2(a) and 16(b)] **[AIMR/CIC92, p. 1]**

Most [CIC] subcommittees agree . . . [that] the following suggestion seems appropriate: [Also included in 1(b), 2(c), 3(b), 3(d), 5(a), 5(d), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3**

- Quarterly reports with timely data presented in a format comparable to that of the annual report. [Also included in 1(b), 2(c), 11(a), and 16(b)]
  [AIMR/CIC92, p. 3]

The questions increasingly raised about the validity of Precept 1, below, give rise to our conviction that more has to be done by the FASB, the SEC, and accounting teachers and researchers to reassert the objectives established for accounting standards by the Trueblood Study Group and the FASB. **[AIMR/FAF91, p. 18]**

Precepts by Which the FASB Operates
Precept 1 [*To be objective in its decision making* and to ensure, insofar as possible, the neutrality of information resulting from its standards]. Users wholeheartedly support the precept that the FASB be objective in its decision making and ensure neutrality of information. Any other approach would render financial statements useless to investors and, we firmly believe, to the economy and society at large. We believe that the FASB has been diligent about trying to achieve neutrality, despite the various pressures brought to bear by its various "constituencies." **[AIMR/FAF91, p. 18]**

No preparer of financial statements, however diligent, can know in advance the goals, objectives, and needs of any given investor, i.e., whether an investment is made in the hope of income over a definite or indefinite period, or in the hope of capital appreciation, again over a predetermined or indefinite period of time, or a combination of both, or for some other reason. The interplay of the various interests, goals, and objectives of investors is what creates the efficiency of the markets and, not at all secondarily, enhances opportunities for capital formation. **[AIMR/FAF91, p. 18-19]**

The FASB's Statement of Accounting Concepts No. 1 (Objectives of Financial Reporting by Business Enterprises) summarizes the objectives and role of financial reporting as investors understand them this way:

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. (Paragraph 34)
>
> . . . The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be. . . . To the extent that financial reporting provides information that helps identify relatively efficient and inefficient users of resources, aids in assessing relative returns and risks of investment opportunities, or otherwise assists in promoting efficient functioning of capital and other markets, it helps to create a favorable environment for capital formation decisions. However, investors, creditors, and others make those decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those

decisions. The role of financial reporting requires it to provide evenhanded, neutral, or unbiased information. (Paragraph 33) [Emphasis added.]
[AIMR/FAF91, p. 19]

The conclusions stated in the Concepts Statement did not, like Venus, spring from the ocean depths fullborn. The Trueblood Study Group discussed a list of the qualitative characteristics of reporting in its Objectives report. Some paragraphs on "Freedom from Bias" are worth repeating. **[AIMR/FAF91, p. 20]**

> Preparers and users, borrowers and lenders, buyers and sellers, special interest groups, and others have primary interests in financial statements. While any information affected by judgments necessarily has some bias, there should be no purposeful bias favoring any group. Absence of bias, which may be characterized as neutrality and fairness, has long been recognized in accounting, although the perception of what is neutral and fair has changed with the times and needs.
>
> In financial statements, avoiding bias which possibly benefits the interests of one group at the expense of another requires that the application of conservatism be carefully considered. Conservatism for its own sake may actually introduce bias. Confining financial statement representations to the results of transactions and other events for which substantial evidence exists and recognizing the varying degree of uncertainty would seem to aid in avoiding bias.
>
> Degrees of uncertainty in accounting information are not disclosed at present. Instead, to avoid possible adverse consequences and to counter possible management bias, the most conservative among alternative accounting treatments has generally been favored. Thus losses, but not gains, tend to be anticipated.
>
> If financial statements do communicate information about varying degrees of uncertainty, about the judgments made and the interpretations applied, and about the underlying factual information, then the impact of surprises--pleasant or unpleasant--will diminish greatly. This should result in a substantial lessening in the belief that conservatism is essential.[7]
> **[AIMR/FAF91, p. 20]**

Focus Group Comments, Analysts: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 1(b), 1(c), 2(a), and 4] **[KPMG BANK STUDY, p. 39]**

- Indicated concern over the amount of subjectivity involved in making fair value estimates and questioned the ultimate usefulness of the results [Also included in 2(a) and 4] **[KPMG BANK STUDY, p. 39]**

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[7] Objectives of Financial Statements, at 58-59.

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(c), 4, 5(a), 5(b), 5(d), and 13] **[KPMG BANK STUDY, p. 39]**

- Generally believed fair value disclosures of financial instruments would be useful provided they were reliable and comparable [Also included in 2(c) and 4] **[KPMG BANK STUDY, p. 39]**

The FASB, the Securities and Exchange Commission (SEC) and other regulatory bodies are currently considering a requirement to prepare financial statements based on market values in place of financial statements prepared on a historical cost accounting basis. The questions in this section relate to this issue: [Also included in 1(b), 2(a), 2(c), 4, 10(b), 11(a), and 15] **[KPMG BANK STUDY,
p. A-9]**

- **Indicate whether you believe fair value accounting should be the primary accounting basis for the preparation of an institution's financial statements.**

  10% Yes
  90 No
  0 No opinion
  [Also included in 2(a), 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-9]**

  [One user commented] no. Grave doubts exist as to the usefulness and accuracy of 'fair value'. [Also included in 2(a), 4, and 15] **[KPMG BANK STUDY, p. A-9]**

  [One user commented] no. Fair market value can be easily manipulated for many financial instruments. In fact, many had commercial real estate loans made based upon 'estimates of market value'. [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-9]**

  [One user commented] no. It is difficult to determine the fair value of many assets and liabilities. This could distort financial statements and hinder comparability. [Also included in 2(c), 4, and 15] **[KPMG BANK STUDY,
  p. A-9]**

  [One user commented] no. Fair value accounting is too judgmental and too susceptible to external factors (i.e., market fluctuations) to serve as the primary accounting basis. [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-10]**

  [One user commented] no. [There is an] inability to accurately adjust values of all asset and liability categories. [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-10]**

  *[One user commented] no.
  --Misrepresents "lending to maturity" aspect of bank loans.
  --Concern about behavioral impact on bankers.*

--Costs more to gather information than benefits users.
--Too much estimation required; comparability and integrity [are] questionable.
--Misuse of information by less-sophisticated users.
[Also included in 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-10]**

- *High degree of subjectivity, and the inherent uncertainty of forecasts on which valuations are based, will diminish both the consistency and comparability of financial institutions' reports.* [Also included in 2(c), 4 and 15] **[KPMG BANK STUDY, p. A-10]**
- *Increase potential for accounting abuses.*
[Also included in 4 and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. Too judgmental once one gets away from liquid and marketable instruments. [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] yes, however, I would qualify my answer by acknowledging that valuation of many loans is subjective. Thus I have serious concerns regarding:
1. *Comparability among more conservative and less conservative banks*
2. *Restrictions in lending/credit crunch involving borrowers, which are very difficult to value.* [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-11]**

- **There are current accounting rules that require the disclosure of fair values, realized and unrealized gains and losses, cash flow information and maturities and yields of investment securities. Considering that this information is already available, indicate whether you believe the historical cost based accounting should be replaced with fair value based accounting.**

8%	Yes
88	No
2	No opinion
2	No response

[Also included in 2(a), 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. Much of the additional information that would be available with fair value accounting must be based on estimates which are likely to incorporate varying assumptions and therefore, is unlikely to be reliable or consistent. Further, much of what is proposed is irrelevant for valuing a banking company. [Also included in 2(a), 2(c), 4 and 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. Most adjustments would be unreliable approximations of improbable or impossible transactions; they would create destabilizing volatility of earnings that would not fairly reflect realities of going concerns. Lack of timeliness of problem also. [Also included in 4 and 15] **[KPMG BANK STUDY, p. A-12]**

- **For an institution that has the intent and ability to hold assets for the foreseeable future (defined as 12 to 18 months), indicate whether you believe fair value accounting is appropriate.**

  30% Yes
  60 No
  8 No opinion
  2 No response
  [Also included in 2(c), 4, 10(b), and 15] **[KPMG BANK STUDY, p. A-13]**

  [One user commented] yes. Some effort at fair value accounting is still useful for these organizations. However, if the subjectivity involved is too great for certain loans so that comparability is destroyed, I would favor historical cost with an explanatory footnote. [Also included in 2(c), 4, and 15] **[KPMG BANK STUDY, p. A-14]**

Estimates of fair value may vary by institution because of different assumptions, methodologies and the practicability of such disclosure. The following questions relate to the reliability and comparability of fair value estimates: [Also included in 1(b), 1(c), 1(d), and 4)] **[KPMG BANK STUDY, p. A-20]**

- **If fair value estimates for financial instruments were only included in the footnotes to the financial statements, select the letter which best describes the amount of measurement error in fair value estimates you would tolerate before you consider these estimates to be misleading.** ***Measurement error is defined as the variance between the precise fair value and the disclosed estimated fair value:***
  - **a. Within plus or minus 1%**
  - **b. Plus or minus 1 to 5%**
  - **c. Plus or minus 6 to 10%**
  - **d. Plus or minus 11 to 20%**
  - **e. More than 20%**
  - **f. Other**
  - **g. No response**

A	B	C	D	E	F	G	
33%	45%	13%			5%	4%	Equity investment securities
35	53	5			5	2	Debt investment securities
	55	30	5	3	5	2	Purchased mortgage servicing rights
	50	35	5	3	5	2	Excess mortgage servicing rights
10	50	23	3	8	5	1	Loans
18	48	15	3	5	5	6	Demand deposits
20	45	15	3	5	5	7	Time deposits
23	50	10		5	5	7	Long term debt
	53	30	5	3	5	4	Financial guarantees
5	45	25	10	5	5	5	Commitments to extend credit
3	53	28	5	5	5	1	Letters of credit
10	55	18	5	3	5	4	Swaps, options, futures, etc.
	3						Other

[One user commented] that for large categories like loans, a 5% value difference would destroy any sense of trend, and could wipe out equity capital.
[Also included in 4] **[KPMG BANK STUDY, p. A-20]**

- **If fair value estimates were the primary basis used to prepare the <u>balance sheet or statement of operations,</u> select the letter which best describes the amount of measurement error in fair value estimates you would tolerate before you consider these estimates to be misleading. Measurement error is defined as the variance between the precise fair value and the disclosed estimated fair value:**
  - **a. Within plus or minus 1%**
  - **b. Plus or minus 1 to 5%**
  - **c. Plus or minus 6 to 10%**
  - **d. Plus or minus 11 to 20%**
  - **e. More than 20%**
  - **f. Other**

A	B	C	D	F	
58%	25%	5%	3%	9%	Equity investment securities
63	25		3	9	Debt investment securities
40	33	15	3	9	Purchased mortgage servicing rights
40	35	13	3	9	Excess mortgage servicing rights
50	23	15	3	9	Loans
50	30	8	3	9	Demand deposits
55	25	8	3	9	Time deposits
53	30	5	3	9	Long term debt
35	43	8	3	11	Financial guarantees
38	35	13	3	11	Commitments to extend credit
35	40	10	3	12	Letters of credit
48	33	3	3	13	Swaps, options, futures, etc.
	5				Other

[Also included in 4] **[KPMG BANK STUDY, p. A-21]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

> [One analyst] believes that management is responsible for the integrity of financial statements, but that the profession has not carried this message to the public. She also believes that the profession should take a more public and positive stand on issues that affect it. [Also included in 18(e)] **[GOLDMAN, p. 2]**

2.b.41

When asked about how much such standards for financial reporting add to the credibility of financial reports, a nearly unanimous 95-4% majority replied that they contributed positively to building a sense of believability about the process and the result.

Table 1.5

HOW MUCH RULES ADD TO CREDIBILITY OF FINANCIAL REPORTS

Q.2B—How much does the existence of these rules add to the credibility of financial reports—a great deal, some but not a lot, only a little, or not at all?

		Large Public Companies							Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
A great deal	61	64	62	58	64	63	67	58	73	60	40	55	58	41
Some but not a lot	34	32	35	39	36	32	31	36	27	20	60	32	34	47
Only a little	4	4	1	3	–	5	2	4	–	13	–	6	5	12
Not at all	1	–	1	–	–	–	–	–	–	–	–	6	–	–
Not sure	*	–	–	–	–	–	–	2	–	7	–	–	3	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

2.5.43

The Issue of Differential Measurement for Small Public And Private Companies Compared with Large Public Companies

Yet another division within the financial community that has been the subject of protracted debate over an extended period of time deals with especially complex transactions for which some argue different standards for recognition and measurement are justified, depending on size or ownership of a company.

First, the sample was asked if there were such complex cases that exist:

Table 1.17

WHETHER THERE IS JUSTIFICATION FOR DIFFERENTIAL MEASUREMENT

Q.6A—Do you feel that there are some particularly complex transactions for which differential measurements are justified, depending on size or ownership?

		Large Public Companies		Small Public Companies	Private Companies			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	C.E.O.	C.E.O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Feel	53	49	54	55	39	54	51	56	47	67	53	71	61	47
Do not feel	43	47	42	45	57	37	46	44	53	33	47	29	34	53
Not sure	3	4	4	–	4	10	3	–	–	–	–	–	5	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Led by small accounting firm executives, technical partners of large accounting firms, and academics, a majority can cite such complex transactions that might justify a kind of two-tier standard for small public and private companies on the one hand, and large public corporations on the other. Curiously, CEOs of private companies by 57-39% say they cannot think of any such transactions.

[HARRIS]

2.b.44

Here are the transactions that those who could recall some had in mind:

Table 1.18

EXAMPLES OF COMPLEX TRANSACTIONS THAT MIGHT JUSTIFY DIFFERENTIAL MEASUREMENT

Q.6B—What would be an example of such a complex transaction? Base: Those who feel there are complex transactions needing differential measurement.

		Large Public Companies						Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	241	38	43	18	11	22	31	25	7	10	8	22	23	8
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Leasing transactions	30	26	40	22	18	9	23	60	86	50	50	50	13	13
Pension accounting	16	16	23	11	9	9	3	28	14	30	38	14	30	–
Deferred tax accounting	17	13	21	17	18	9	–	40	43	30	50	32	13	13
Disclosure information	9	13	7	11	–	5	3	16	29	20	–	9	13	–
Inflation accounting	12	16	30	11	18	5	3	4	–	10	–	9	–	–
Mergers/acquisitions	10	5	–	22	–	18	23	8	–	10	13	9	4	38
Leveraged buyout	2	3	–	6	–	5	6	–	–	–	–	–	–	13
Foreign exchange transactions	5	5	2	11	–	5	10	–	–	–	–	5	4	–
Earnings per share	4	8	–	6	–	–	–	–	–	–	–	14	13	–
Employee benefits/ plans	3	3	5	6	–	5	3	4	–	–	13	5	–	–
Capitalization of interest	1	–	2	–	–	–	–	4	14	–	–	5	–	–
International operations/financing	4	3	5	6	–	9	–	–	–	–	–	–	13	13
Stock options/issues	5	5	12	–	–	–	6	4	14	–	–	9	–	–
Segment reporting	3	3	5	–	–	5	3	8	–	20	–	–	–	–
Any other mentions	32	32	26	33	45	36	45	12	–	20	13	32	35	50
Don't know/ no answer	12	13	9	17	18	23	6	4	–	–	13	9	13	13

Among the main complex transactions that sizable numbers feel would qualify as special cases that could well require differential measurement are leasing transactions, pension accounting, deferred tax accounting, certain types of disclosure information, inflation accounting, and mergers and acquisitions.

[HARRIS]

2.b.45

And yet upon further reflection, among a narrow 51-47% majority of the entire sample, led by CEOs of large public companies, CEOs of private companies, bank lending officers, and financial media people, there is a real sense that accounting for such transactions separately and differently could well affect the credibility of financial reporting in general.

Table 1.19

WOULD DIFFERENTIAL MEASUREMENTS ON COMPLEX TRANSACTIONS AFFECT FINANCIAL REPORTING CREDIBILITY?

Q.6C—If the same kinds of transactions and events were accounted for differently depending on size or ownership, do you feel this would affect the credibility of financial reporting in general?

		Large Public Companies		C.E.O.				Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Would affect credibility	51	55	46	52	57	49	61	51	53	47	53	39	37	71
Would not affect it	47	42	54	48	43	44	34	49	47	53	47	58	63	29
Not sure	2	3	–	–	–	7	5	–	–	–	–	3	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *While a 53-43% majority said they can think of cases of complex transactions where differential measurements are justified, nonetheless, a 51-47% majority also said that adoption of such differentiation could well diminish the credibility of financial reporting in general. Thus, the message is that while some merit can be seen in this issue, the FASB should go slow in adopting sweeping change.*

[HARRIS]

Relevance and Reliability

2.b.47

As in the 1980 survey, key FASB constituents and observers were asked about the question of relevance and reliability in reporting financial information. First, they were asked if at some point one of these qualities might have to be sacrificed in order to gain the other:

Table 4.5

WHETHER RELEVANCE OR RELIABILITY SHOULD BE SACRIFICED

Q.12D—In an ideal world, all financial information would be *both* relevant and reliable. But, in the world of *reality*, do you agree or disagree that there are times when one of these qualities has to be sacrificed some in order to gain the other?

	1985	1980
	%	%
Agree sacrifice sometimes needed	59	41
Disagree, not needed	38	54
Not sure	2	5

In the five-year period since 1980, a dramatic turnabout in attitudes obviously has taken place. Back in 1980, a majority did not think it necessary sometimes to sacrifice relevance or reliability for the other. Now, a clear majority feels that it is necessary to do so at times.

Following is a breakdown by 1985 respondents on whether a sacrifice of relevance or reliability is sometimes needed.

Table 4.6

SACRIFICING RELEVANCE OR RELIABILITY: BREAKDOWN BY RESPONDENTS

		Large Public Companies		Small Public Companies C. E. O.	Private Companies C. E. O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers					Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Agree	59	54	63	61	61	44	48	76	93	53	80	48	84	59
Disagree	38	46	37	36	39	44	49	22	7	40	20	45	16	41
Not sure	2	–	–	3	–	12	3	2	–	7	–	6	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

2. b. 48

When asked to choose, as in 1980, a substantial majority would sacrifice relevance for reliability:

Table 4.7

WHETHER RELEVANCE OR RELIABILITY CAN BE COMPROMISED

Q.12E—In general, if you had to choose, which do you think ought to be compromised if either some relevance or reliability had to be sacrificed—*relevance* or *reliability*?

	1985	1980
	%	%
Relevance	65	65
Reliability	23	16
Both	3	3
Neither	2	*
Not sure	6	16

*Not measured in 1980.

Observation: *As in 1980, a sizable majority would opt to sacrifice relevance if a choice has to be made, but a slightly larger portion of the sample would be willing to sacrifice reliability in 1985.*

Following is the 1985 breakdown by categories of respondents.

Table 4.8

RELEVANCE VS. RELIABILITY: BREAKDOWN BY RESPONDENTS

		Large Public Companies		Small Public Companies	Private Companies			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	C. E. O.	C. E. O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Relevance	65	63	59	79	75	80	79	60	40	80	60	71	29	53
Reliability	23	18	30	15	14	7	8	36	53	13	40	16	63	29
Both	3	9	3	3	–	–	–	–	–	–	–	3	5	–
Neither	2	4	1	3	–	2	3	–	–	–	–	3	–	12
Not sure	6	5	6	–	11	7	10	4	7	7	–	6	3	6
No answer	*	1	–	–	–	2	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

2(c). Comparability, excluding Alternative Accounting Procedures

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to criticisms of financial reporting. . . . **[FASOversight, p. 1]**

- The increase in "Other Comprehensive Basis of Accounting" financial statements increases the lack of comparability of financial information. [Also included in 14] **[FASOversight, p. 1]**

- Comparability and consistency in financial reporting practices over a long period of time, generally 5 to 10 years, is very important in comparing an enterprise's performance and financial position within its industry and across industry lines. [Also included in 1(b)] **[FASOversight, p. 2]**

[F]inancial analysis in general and credit analysis in particular relies on comparisons. Interperiod consistency in reporting allows, for a single firm, comparison of data from one reporting period to the next (time series analysis). Interfirm comparability in reporting allows comparison between and among different firms (cross-sectional analysis). Internal consistency allows comparison of one financial statement datum to another (financial ratio analysis). **[RMA90, p. 1]**

The standards-setting group should provide leadership in controversial areas. The results of its deliberations should be standards that satisfy the practical needs of users in addition to being conceptually sound and technically feasible. **[RMA90, p. 2]**

There should be only one set of generally accepted accounting principles applicable to general purpose financial statements for all business and non-business enterprises, regardless of whether the entity is public or private, regulated or non-regulated, large or small. A major objective of financial accounting standards should be to eliminate (or, at least, reduce) the use of alternative accounting methods under similar circumstances. Such alternative practices contribute to a loss of comparability and thus reduce a financial statement user's ability to judge relative risks. Standards should reflect an optimum combination of reliability and relevance, and should apply only to items that are material in size. [Also included in 14] **[RMA90, p. 2-3]**

The first objective of financial statements is to provide information that is useful and informative to several classes of financial statement users. Accounting data are the primary means by which readers assess the financial position, results of operations, and cash flows of economic entities. Individual classes of users may require additional data to serve their specialized need, but such data should be furnished by means that are supplementary to the primary general purpose financial statements. [Also included in 1(b)] **[RMA90, p. 3]**

Understandability is an important characteristic of accounting data. The [two] items listed below are vital to understandability. **[RMA90, p. 3]**

- Conceptual support: Financial accounting standards should emanate from a sound conceptual framework that ensures consistency, comparability and neutrality. [Also included in 2(b)] **[RMA90, p. 3]**

- Limits on accounting changes: Changes in financial accounting standards are welcome only when existing standards are deemed inadequate. The APC [Accounting Policy Committee] points out that significant costs to users attach to new standards that do not preserve the consistency and comparability of financial reports. **[RMA90, p. 3]**

The APC [Accounting Policy Committee] believes that it is better not to apply new standards to transactions of the past. But, when a cumulative retroactive effect of a change in standards must be computed, its effect on the earnings of each prior year must be disclosed so that the income of those years can be adjusted to be made comparable to income that will be reported in the future under the new standard. **[RMA90, p. 3]**

To the extent that earnings, earnings momentum and earnings potential drive the equity analytics of sell-side reports, the need for more frequent than annual information on performance is clear, as is the need for more finely disaggregated performance information, in common sized formats to enhance intercompany comparisons. [Also included in 1(a), 3(c), 3(d), and 11(a)] **[PREVITS, p. 21]**

The implications [of increased availability and use of databases] for both financial analysis and financial reporting are profound. A common computer expression is GIGO (garbage in, garbage out). Much of the analysis work performed by computers involves comparisons of company-specific data or of ratios constructed from those data. One needs to read but a few annual reports to realize that such comparisons are fraught with danger if made on the basis of unadjusted data. There are too many dissimilarities in how different companies record similar transactions, events and happenings to draw any but rough comparisons from unadjusted data. Some services, such as COMPUSTAT, attempt to adjust the data themselves; others do not. The need to adjust will be diminished and the quality of comparisons elevated to the extent that financial accounting standards produce financial statements that are consistent from period to period and comparable from company to company. That is a goal to be coveted, but analysts themselves should realize it will never be totally attained. [Also included in 16(a)] **[AIMR/FAPC92, p. 15]**

In the real world, obviously not all of these objectives can be achieved. They require trade-offs and choices. From the standpoint of financial analysis, we believe priority should be given to the production and dissemination of financial data that reflects and reports sensibly the operations of specific enterprises. If we could obtain reports showing the details of how an individual business firm is organized and managed, we would take more responsibility on ourselves to make meaningful comparisons of those data to the unlike data of other firms who conduct their business differently. We realize the extraordinary difficulty of mandating a disclosure standard while maintaining the flexibility of each enterprise to present its own circumstances and organization, but we believe it to be a commendable undertaking. [Also included in 3(b) and 3(c)] **[AIMR/FAPC92, p. 40]**

[Context] The following brief summary of the topic "Transition to New Standards," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Financial analysts support the issuance of accounting standards that improve the quality and quantity of financial information. The antithesis is that any new standard disrupts or destroys time-series analysis by making future periods' financial reports not comparable to those of the past. We have observed a trend towards exacerbation of that situation in the transition methods permitted by the FASB in several recent standards. first, there are delayed final adoption dates, thus permitting extended periods of noncomparability between the financial statements of early adopters and those of companies that wait until the final date to adopt. Second, there are choices of method -- restatement, cumulative effect, or (worst of all) delayed effect. In the case of ***FAS 106***, it will be twenty years after the final adoption date before we begin to have total comparability among enterprises. In the meantime, it takes an astute and fortuitous reading of complex footnotes to ferret out the truth. In this section we recommend single transition methods and short transition periods. **[AIMR/FAPC92, p. ix]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

All fundamental analysts use databases of one sort or another. They may be commercial in origin or they may be assembled by the analyst himself or herself. They may be accessed electronically or they may be in hard copy form. They may be extensive or limited in scope. The point is that they are used to make comparisons between and among firms, and over periods of time several years in length. The validity of those databases may be enhanced in one sense, but certainly will be impaired in another every time a new accounting standard is issued. As some or all enterprises adopt the new standard, it ought to have the effect of improving interfirm comparisons by eliminating differences attributable only to accounting. But it is certain to destroy the continuity of previous periods' accounting numbers with those of the present and future. [Also included in 16(a)] **[AIMR/FAPC92, p. 48]**

It should be apparent that AIMR does not oppose the issuance of new accounting standards. Indeed, much of this report is devoted to suggesting changes that we feel would improve the

usefulness of financial reports. Our objective in this section is to advocate methods of transition to new standards that would precipitate minimum disruption to the continuity of data analysts use. **[AIMR/FAPC92, p. 48]**

We have sincere reservations about the transition methods and procedures specified by FASB pronouncements issued in recent years. Perhaps the epitome of our concern came with the issuance of FAS 96 in 1987, followed by FAS 100 in 1988, FAS 103 in 1989, FAS 108 in 1991 and FAS 109 in 1992. FAS 96, which set new standards for reporting income taxes in financial statements, permitted two transition methods and a three-year transition period. An enterprise could choose to adopt FAS 96 in 1987, 1988 or 1989. The adopting enterprise could choose to restate as many of its prior years as it wished, or it could choose to place the entire cumulative retroactive effect of the change on the income statement of the year it adopted FAS 96. FAS 100 extended the effective date of FAS 96 from 1989 to 1990; FAS 103 extended it further through 1992; and FAS 108 extended it through 1993. Finally, FAS 96 was superseded by FAS 109, which also has a 1993 effective date and continues the choice of transition methods allowed by FAS 96. **[AIMR/FAPC92, p. 48]**

We realize that there were special circumstances attaching to the replacement of FAS 96 by FAS 109, but the impact on analysis was devastating. Starting in 1987 and continuing through 1993, seven full years, we have had to compare companies using up to three different paradigms of accounting for income taxes. Many firms continue to follow the provisions of Accounting Principles Board Opinion No. 11 and will persist in doing so until forced to switch in fiscal year 1993. Others have adopted FAS 96 but have not yet made the transformation to FAS 109. Still others are early adopters of FAS 109. Furthermore, at the time that firms adopt FAS 109, there still are differences in the disposition of the cumulative effect of the change on prior years' income. It will not be until 1994, when analysts begin receiving 1993 annual reports, that we will have comparable data on income taxes among all firms. And it will sometime into the twenty-first century before analysts will have a sufficient number of comparable years of data to do sensible time-series analysis on reported income tax numbers. **[AIMR/FAPC92, p. 48-49]**

If FAS 96 and its successors were an isolated instance, our cause for complaint would be modest. But it is not. FAS 106, "Employers Accounting for Postretirement Benefits Other Than Pensions," has resulted in perhaps the most sizable cumulative adjustments in the history of standards setting. Companies adopting that standard also have been given considerable time (1990-1993 for domestic plans: 1990-1995 for foreign plans) and a choice of methods (immediate or delayed recognition of the transition amounts). In one way, FAS 106 is much more destructive of database construction than FAS 96 and its successors. Delayed recognition of the transition amount will extend over twenty years subsequent to adoption of the statement. For enterprises adopting it for domestic plans in 1993, their financial statements may include this vestige of the past until the beginning of fiscal year 2013. It will take an astute and perspicacious financial statement reader to abstract from footnote data required by FAS 106 the facts necessary to adjust financial statements to be comparable. Those who rely on commercial databases do not even have the opportunity to make such adjustments. [Also included in 16(a)] **[AIMR/FAPC92, p. 49]**

It seems as if the FASB has tended in recent years towards longer transition periods and more choice on the part of business firms on how to account for mandated changes in accounting principles. We understand that motivation for such flexibility derives from the complexity of certain recent standards as well as the magnitude of their effect of financial statements. From the standpoint of financial analysts, recent relaxation by the FASB of quick and strict transition procedures are untimely. Increased availability and use of electronically-accessed financial databases, with the promise of the SEC's EDGAR scheme to be available soon, reduces substantially opportunities for analysts to fashion the tedious adjustments necessary to make financial statements comparable. Furthermore, analysts should not need to make such adjustments. Long transition periods and multiple methods may be politically prudent, but they dramatically reduce the usefulness of financial statements. [Also included in 16(a)] **[AIMR/FAPC92, p. 49]**

We would be better served if those who set standards and disclosure rules would designate a common date for adoption of a new accounting standard and a final date for complying with a new disclosure requirement. We also urge those dates to be as soon as feasible after the new rules are promulgated and published. Standard setters and capital market regulators need to gather evidence on feasibility as part of their normal processes. The collection of evidence needs to go beyond merely hearing the assertions of business enterprises about their anticipated difficulties in applying the prospective rule(s). As we note below, field testing often can be a vital ingredient in making transition more rapid and productive for all. [Also included in 16(a)] **[AIMR/FAPC92, p. 49]**

Most important of all to financial analysts with respect to transition is the need for a single method. We have observed, without surprise, that the existence of choices has introduced bias into financial reports. Any sensible financial manager, given a choice of methods, must select the one that makes his or her firm look best, if for no other reason than not to appear irrational to those who provide capital to the firm. As a result, we tend to see cumulative effect credits appear on current and future-period income statements, while equivalent debits go directly to owners' equity. Given the equality of debits and credits, a new debit to the past can only result in equal credit to current or future periods, sometimes revealed and sometimes not.[18] **[AIMR/FAPC92, p. 50]**

Transition that requires a restatement of prior periods to the new method is preferred to all other methods. Presumably, a change in standards is promulgated to effect improvement. If prior periods' reports can be restated to achieve those same improvements, we will have new information about the past. More importantly, restatement gives financial analysts a head start in constructing a new time-series data base. Restatement starts us off under the new standard with three years of data under the new method. Our only concern with restatement is that it is

[18] We are fascinated by the enterprise that elected early adoption of *FAS 96* via restatement, thus reducing its retained earnings by hundreds of millions of dollars of "derecognized" deferred income tax benefits. In subsequent years, that firm's unrecognized deferred tax benefits decreased, thus reducing the income tax provision and increasing net income compared with its previous accounting for income taxes. That same firm then elected early adoption of *FAS 109*, but chose to recognize the cumulative retroactive effect of the change as an adjustment of income. As a result, all of the hundreds of millions of deferred tax benefits "derecognized" at January 1, 1987, ended up appearing on the income statement twice. We do not fault the financial managers. They did what they had to do. We do regret the opportunity being available to them.

not in accordance with the concept of comprehensive income which we advocate and promote throughout this report. As a practical matter, however, the comparability attained through restatement for accounting principles changes is more important to analysts than strict adherence to our support of comprehensive income. **[AIMR/FAPC92, p. 50]**

In some cases, it is impossible or impractical to restate the past for the effect of a newly-issued financial accounting standard. Examples that come to mind are changes resulting from the issuance of FAS 34, "Capitalization of Interest Cost," FAS 52, "Foreign Currency Translation," FAS 76, "Extinguishment of Debt," and a variety of amendments and changes to existing accounting standards.[19] In those cases, the cumulative retroactive effect of the change, if it can be computed, should be reported on the current period's income statement separately and with full disclosure. We are unable to perceive conceptual grounds for carrying any such cumulative effect forward and, even worse, using it to smooth the incomes of future periods. If the latter procedure is mandated or allowed anyway, its effect on the income of each and every future period affected not only must be disclosed, it should additionally be presented separately from events of the current year or else highlighted to point it out clearly to otherwise unsuspecting readers of the financial report. **[AIMR/FAPC92, p. 50]**

In some cases, a new standard may be applied only to transactions originating after a specified date, for reasons that either are practical or political. We believe such treatment is justified only in rare cases, and carries with it a responsibility on the part of reporting enterprises to inform financial statement users of the extent to which that new standard has affected them as long as there are material amounts carried forward from the past under different accounting. **[AIMR/FAPC92, p. 51]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the types of information they use to achieve their objectives and the way they use that information, some investors made a comments on the comparability of the information.

Participant I-1
The first one on the list (taking out nonrecurring items) is the most common adjustment but the question we have with nonrecurring is whether it really is nonrecurring? If they're taking a $200 million charge every year in the third quarter, is it nonrecurring? You also get into the issue of comparability of statements from year to year because if there is a regular pattern of charge-offs in a given company, generally it will have an industry effect. So you'll have a number of companies in an industry having charge-offs in different quarters and different years. So comparing companies' results with their competitors becomes extremely difficult. Another issue is the components of the nonrecurring charges, how they were determined. You always think a company has taken a very large reserve because they don't want to provide again. [Also included in 1(b)] **[TI 10/16, p. 31]**

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[19] The fact that we cite *FAS 34, FAS 52* and *FAS 76* as examples where restatement would not be advisable is in no way related to the fact that each of these is a standard whose issuance financial analysts believe worsened rather than improved the quality and usefulness of financial reporting.

Participant I-11
I think all of us from time to time will make all or most of these adjustments. The issue of comparability is one that arises frequently and is perhaps the most common reason I make adjustments to financial statements. But I am against a real strong stand by the accounting profession on doing away with choices. I'm thinking specifically of the decision made in the interest of comparability that nonfinancial companies had to consolidate their finance subsidiaries. Now when I look at a company, I don't know what I'm looking at. I think that was a terrible decision because it has reduced the amount of information available to me. So, I think we are all for comparability but I'm not sure it's universally good. [Also included in 1(b) and 8(a)] **[TI 10/16, p. 33]**

Participant I-6
I try to come down to what are the earnings from the current businesses that are there today, and are they going to be the same ones next year? So, if they have written off a complete line of business, I back it out and get rid of it. What I have seen from a couple of companies I follow, and what I would like to see, is two EPS numbers; one is the traditional GAAP reporting number, and one based on the earnings excluding the nonrecurrng items and comparing them to the prior period excluding the same things so that we have some comparability. But that is just starting to come out. [Also included in 1(b) and 5(a)] **[TI 10/16, p. 41]**

Participant I-1
I think it is also relevant for companies that are oriented toward mergers and acquisitions. You deal with issues of trying to compare apples to apples and trying to find out where is the real growth coming from. [Also included in 1(b)] **[TI 10/16, p. 41]**

Committee/Staff/Observer
I heard people say that they would like to have more segment information presented the way the company manages its business. But I also heard people say they'd like to have segment information comparable between companies. It seems to me that is contradictory. How do you reconcile that contradiction? [Also included in 3(b)] **[TI 10/16, p. 60]**

Participant I-7
When I talk about comparability, I'm talking about accounting elements, I'm not talking about segment information. At least in my industry, they're not producing a common product; you shouldn't force two companies to look at their segment reporting in the same way. [Also included in 3(b)] **[TI 10/16, p. 60]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information. Some comments on comparability were made during the discussion.

Committee/Staff/Observer
The problem with that is that we hear obvious complaints about FASB 14; you want more segment reporting and you also want more uniformity so there can be comparability. There is a dichotomy there: how can different companies report in a way that gives you comparability and at the same time you want the companies the report the way they run their business. Those are two conflicting thoughts. Can we discuss that dichotomy? [Also included in 3(b)] **[TI 12/9, p. 6]**

Participant I-7
I accept differences, even in the same business, for the companies that I look at. The quality that I demand is information. I want the information so that I can understand those differences and make as clear an interpretation as I possibly can. On my side, I will tell the company that there is information that we, in the public eye, should not receive; union information, early pricing, product strategies, new products, and the like. But there isn't a medium to large size company that doesn't know what their competitor does within a very reasonable order of magnitude. And any analyst around this table will tell you that you tend over time to find out more about a company from the competition than from the company itself. [Also included in 3(b) and 3(c)] **[TI 12/9, p. 7]**

Participant I-12
Most of the companies I cover are highly regulated and some are just ridiculously regulated. The interesting thing about this is that you have a single business which will have competitors, some of whom are regulated and others of whom are not regulated and abide by different rules. My favorite example goes back to bank and bad loans. When a bank has a bad loan, 100% of the loan has to be noted as not paying interest. Whereas [name deleted] had a loan for $60 million of which $15 million was classified as non-performing; under their reporting rules, that $15 million is their estimate of their potential ultimate loss. Whenever I see anything from them related to loans, I just multiply by 4! I don't know if it's an accounting profession problem but this is an issue, and I doubt that the financial services industry is the only industry with that kind of problem (differential accounting for the same kind of situation). It's very important in terms of line of business reporting. [Also included in 3(b)] **[TI 12/9, p. 14]**

Participant I-7
That's why I argue for the allowance of differences so long as there is disclosure. [Also included in 3(b)] **[TI 12/9, p. 14]**

Participant I-12
There are a few companies that change how they look at segments about every 2 years. So you get one year's worth of comparable, then the next year they change it. To try to get a 5 year history is extremely difficult. The company [name deleted] says that they do this because they have reorganized the fundamental way they do the business. It would be nice to have some disclosure to assess how much of the revenues, for example, have been altered as a result of the change. [Also included in 3(e)] **[TI 12/9, p. 29]**

Participant I-4
[Participant I-12], would [name deleted] recast old figures when they do that? [Also included in 3(e)] **[TI 12/9, p. 29]**

Participant I-12
They will recast for one year, so you get a year over year comparison. [Also included in 3(e)] **[TI 12/9, p. 29]**

Participant I-6
I would like to see a 5 or 10 year requirement for segment disclosure. My companies do the same thing, they're constantly reshuffling and reorganizing. I'm not opposed to that but they should give us a 5 year history or give us more detail beyong 3 or 4 major categories of segments, which means that the detail within it is more meaningful. [Also included in 3(e)] **[TI 12/9, p. 29]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of unconsolidated entities. During the discussion, comments were made on the comparability of information.

Participant I-4
I agree. There is also the question of annual comparability in these areas too; changes in the investments and in the joint venture line. [Also included in 6] **[TI 12/9, p. 37]**

Participant I-6
I think what [participant I-4] might be saying is that it may not be meaningful because it's not comparable and it may be misleading because the current disclosure gives you a sense of security that you shouldn't have. [Also included in 6] **[TI 12/9, p. 39]**

Participant I-4
That's basically right; you can compare unlike entities and think they are similar. [Also included in 6] **[TI 12/9, p. 39]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on comparability.

Committee/Staff/Observer
If you're looking at two companies, one bought a plant in 1992, the other in 1980, so there is a significant difference in costs of acquisition. They both sell the same products to the same customers. How would your analysis be affected, if at all, because the cost structures of the companies would be different? [Also included in 4] **[TI 1/13, p. 25]**

Participant I-12
Theoretically, on an economic value basis, the two companies selling the same products at the same price ought to be worth the same amount of money. Although there might be some difference in efficiency or deficiency. [Also included in 4] **[TI 1/13, p. 25]**

Participant I-7
The real market is not going to reflect that; it's looking at the bottom line. [Also included in 4] **[TI 1/13, p. 25]**

Participant I-5
The financial statements of those two companies are going to look radically different, but you're telling me that they should be valued the same. The only way I'm going to find out that they should be valued the same is to go back and figure out what years the companies bought their plants. I'm going to look at cash flow from operations and required capex to keep you at the same level. It's a much more convoluted process than it would be if the statements were identical. [Also included in 4] **[TI 1/13, p. 25]**

Participant I-12
If you're looking at cash flow, the only impact that that transaction has on the income statement is the depreciation and the interest expense. [Also included in 4] **[TI 1/13, p. 25]**

Participant I-14
On the manufacturing company, I find it very hard to believe that the building that was put up in 1980 has not had substantial modifications to produce a product that would be sold in 1992 and that would be reflected in the equipment account. Where something like this would be more appropriate is in the retail field where there are always changes. Also, since retailers predominantly lease, the cost of the leases has an enormous impact on the bottom line. So I think that the more realistic question would relate to retailing rather than manufacturing. [Also included in 4] **[TI 1/13, p. 25-26]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display. During the discussion on income statement display, an investor made a comment related to the issue of comparability.

Participant I-12
Another point is that companies that run similar businesses report in vastly different fashions. The income statement of [name deleted] is vastly different from the income statements of other kinds of financial companies; yet, their basic business is very similar. So there is an issue of

noncomparability for comparable businesses, both in the income statement and the balance sheet. [Also included in 5(a)] **[TI 1/13, p. 34]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting. During the discussion, comments were made on comparability of information.

Committee/Staff/Observer
We hear that analysts want 11 years of information. You're suggesting one quarter? [Also included in 1(b) and 11(b)] **[TI 3/17, p. 38]**

Participant I-7
[I]t's not 11 years, it's 10 years. And we only want 10 if there is consistency. For example, I have companies that are selling businesses every 3 years. Under APB 30, they will go back and only give you 2 or 3 years of historical performance. We have a problem with companies that every several years do something so significant that the historical pattern of earnings or operating returns has been lost. [Also included in 1(b) and 11(b)] **[TI 3/17, p. 39]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on comparability of external reporting.

Participant C-1
If we get just away from segment information, one of the problems that we run into with industry information is the lack of commonality of disclosure. **[TC 12/8, p. 21]**

Participant C-4
I think there was a question in here as to when we get this information. I would say the better the credit risk, the less information we get, and the less willing management is to provide that information. So I could see some benefit to giving some standardized information to enhance our underwriting of various risks. [Also included in 1(b)] **[TC 12/8, p. 26]**

Participant C-1
The thing is the smaller the company, the less you need it, because the less likely they are in separate, different segments. A lot of companies . . . that we consider public consider themselves to be non-public. And it should be consistent accounting across all the entities. [Also included in 3(e)] **[TC 12/8, p. 34]**

Participant C-15
I just have a point on consistency. We compare one company with another, or one company to an industry, and a lot of times it's difficult to obtain the information, be it segment or other types of balance sheet or income statement information, and to be able to do the comparisons on a consistent basis. **[TC 12/8, p. 41]**

Participant C-6
That's exactly my thought. I see too much differential as far as reporting from, even the same accounting firms, as far as from one year to the next, not getting the same information in the same format. The lack of consistency is sometimes very frustrating. I think that's very important. **[TC 12/8, p. 41]**

Participant C-14
I perceive a lot of the overload to be in the footnotes, but I also find the footnotes to be the most useful part of the financial statements. And I tried to think of how to enhance the understandability of that information, and I think we started to touch on it when we said well, in the footnotes you find the nominal amount of the swaps, but you really don't know what the impact could be. We also need information on the assumptions used by a company or the reasoning for the assumptions they chose in their accounting methods. For instance, why did [one company] pick a 12% return on plant assets, it's 11 or 12%, when inflation is you know, 3 or 4%? Or why did [another company] depreciate its video over 36 months when the economic life is only four months? I'd like to know more about why they choose those kind of things. Or other examples would be why they've changed accounting standards. [Also included in 1(b), 2(a), 9, and 19] **[TC 12/8, p. 41]**

Participant C-1
I just would like to second this concept of consistency. It's not a matter of information overload, it's a matter of trying to readjust everything to get some sort of consistent numbers. And with more complicated accounting standards coming out, it's going to become even more complicated and more difficult to get consistent numbers. **[TC 12/8, p. 42]**

Participant C-13
I have a thought unrelated to the small company issue but that should be laid on the table. That is that many investors, particularly large investors, are relying increasingly on databases for compiling, filing, and using financial information, and that's going to increase very significant when the SEC completes its EDGAR project. So this question of consistency is particularly relevant because the information doesn't go through any kind of quality filter before it gets into the database for comparability from year to year, from company to company, consistency over time. [Also included in 16(a)] **[TC 12/8, p. 43-44]**

Participant C-15
I think that going forward, the adjustments that we're going to have to make for FASB 106 are going to make everything historically pale by comparison. And that's going to be a real issue in terms of what the disclosures are going to be and trying to get comparabilities when some

companies choose to amortize the funded liability, and some companies are writing it off. [Also included in 1(b)] **[TC 12/8, p. 45-46]**

[Context] Responses to the postmeeting questionnaire of the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 5

b. Many at the meeting expressed a preference for disaggregated disclosures that are consistent with the way management responsibility is delegated within the reporting organization. At the same meeting, suggestions were made for reporting improvements that enhance the comparability of financial reports by industries/disaggregated units within the same industry. It can be argued that allowing/encouraging disaggregated disclosures along the unique lines of authority within an organization frustrates intercompany comparability. That is, similar companies with similar industrial activities might provide significantly different disaggregated information to the extent their internal organizations differ.

Help us better understand your needs by answering the following regarding the relative importance of disaggregated disclosures versus comparability:

i. Do you agree that allowing companies to use subjective criteria for how information is disaggregated could result in less comparable information?

16 YES   **1** NO

If NO, please explain your response:

Participant C-3 - Absolutely!

Participant C-15 - Maybe there should be more than one basis of presentation.

Participant C-7 - As a bank, our primary focus is the operations of our borrower. The ability to obtain disclosure is a matter for negotiation, not mandate.

Participant C-12 - 1) Less comparable with what? 2) Most companies manage to units that are fairly obvious, *i.e.*, there aren't many ways to divide a business, and managers at different companies tend to agree on the appropriate divisions (and competitive pressure force companies to align their businesses similarly to competitors). 3) Company management will respond to greater disaggregation by lining up their businesses along common lines: competitions will demand this and investors will demand this.

Participant C-11 - Except for small, single-product companies, there isn't that much comparability in a narrow sense. I vote for relevance and reliability over comparability.

ii. Do you have suggestions for mitigating the effects of disaggregation by management responsibility on comparability?

Participant C-3 - I would never promulgate a standard that uses management responsibility as a basis for disaggregation, because it allows the reporting entity too much leeway in reporting results. You'll get <u>less</u> detail (for example, management could easily realign the organizational structure to support less detailed disclosure).

Participant C-14 - The key is to be able to analyze the cash flow generating capability and resources of the <u>borrowing</u> entity.

Participant C-15 - See i.

Participant C-12 - 1) A lot of companies aren't comparable to anything now, so breaking them into pieces, some of which are more easily compared, will be an improvement on the current situation. 2) Breaking businesses into "unitary" components makes them useful without direct comparisons: (a) level and trend of profits by unit, (b) concentration/diversification of profits.

Participant C-5 - Minimum standards by legal structure, product and geography could sustain comparability.

Participant C-4 - Allow for disaggregation by management responsibility, but require management to disclose why their disaggregation method is preferred and to disclose what industries are <u>proportionately</u> included in their disaggregated segments.

Participant C-11 - No. Ultimately, pressures from analysts and preparers and the good will of company managements are the essential elements for good segment disclosure.

Participant C-13 - I believe that the management responsibility criteria is not the most helpful, but it has the advantage that managements cannot claim that the costs of preparing the information exceed the benefits, since they must prepare the information for due diligence on part of Board, etc. Maybe better definitions and more oversight by SEC of compliance with FAS 14.

iii. If you believe there is an inherent conflict between 1) the management responsibility approach to disaggregation and 2) comparability, which should be given <u>greater</u> importance in financial reporting:

10 _ Comparability

6 _ Disaggregation

Comments:

Participant C-14 - As industry analysts, we tend to know how a company should be performing within the peer group. What we need is to have the disaggregated information to make a more meaningful analysis of the borrowers inherent ability to repay.

Participant C-10 - Our goal is comparing disaggregated data for that one company - not against industry data.

Participant C-7 - In commercial lending, each transaction is somewhat unique, disaggregation would provide greater insight into the operations of our borrowers.

Participant C-12 - I can always make adjustments for greater comparability, but I can't disaggregate by myself.

Participant C-5 - 1) Legal disaggregation, 2) Comparability and 3) Disaggregation.

Participant C-4 - Comparability to industry results and to historic results of the segment are vital. Objectivity and consistency are essential for this comparison.

Participant C-18 - Comparability - STRONGLY!

Participant C-9 - Those interested in further information by management responsibility may well be in a position to request it.

Participant C-2 - Comparability is critical to the comparisons of a borrower's financial information to others within the same industry, which is an integral part of the credit analysis.

Participant C-13 - Tough call!
[Also included in 3(b)] **[PMQC 12/8, p. 13-16]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, a comment was made on qualitative aspects of external reporting.

Participant C-4
We rely on the consistency and comparability of historical cost analysis. I don't think that the information we'll be getting from an auditor on fair market value is information that would not otherwise be available to us. We feel that historical cost consistency is much more important in our analysis than fair market value. [Also included in 4] **[TC 2/2, p. 3]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of alternative accounting procedures. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-14
As a matter of policy, comparability of financial statements should have a really high priority. In some areas, I guess, you could make arguments for why some companies do it one way versus another. For the most part I guess I prefer that they have disclosure rather than eliminating choices. [Also included in 8(a)] **[TC 2/2, p. 36]**

Participant C-5
We do make some conversions, primarily the inventory conversion. But I think the concept of consistency among financial statements is important. And I think it will become increasingly important over the next five years. [Also included in 8(a)] **[TC 2/2, p. 37]**

Participant C-13
Philosophically, I'm in favor of one measure of accounting. What [participant C-14] said about comparability, I couldn't agree with him more. [Also included in 8(a)] **[TC 2/2, p. 38]**

Committee/Staff/Observer
Within the same company? [Also included in 8(a)] **[TC 2/2, p. 38]**

Participant C-13
No, within the industry, between other alternative investments. What the institutional investor is doing is choosing between a broad range of alternatives, not looking at one individual lending decision. When you're lending, you're not deciding whether you're going to lend to this company or that company. And to the extent that you have comparability, direct comparability between the statements of one or the other, it makes the job easier. You don't have to make the various adjustments. Now, in the case of full cost and successful efforts, there isn't enough information on the statements in order to make those kinds of comparability judgments. You've got to get behind it and find out. I do think of the four that are mentioned, I don't think we'd have any problem about trade date and settlement date. [Also included in 8(a)] **[TC 2/2, p. 38]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-7
I think one of the benefits on the credit side is the consistency over time for comparability, as we make our credit decisions with our borrowers and continue to monitor the relationship. We are measuring the same things over time so that we have a feel for the true performance of our borrowers. [Also included in 17(a)] **[TC 3/11, p. 1]**

Participant C-17
I think that what really shakes the confidence of the user community is the propensity to have a series of surprise adjustments or write-offs. And it always seems to group itself around

periods of economic stress. Clearly, something is not happening. I think that what we want is simple enough: adequate disclosure. All of us want independence. In terms of the accountants' participation in projections and all that sort of thing, we really would rather hear it from our company. We want consistency. It's very difficult to make accurate assessments about what's going on with a company if they're changing the way they make their presentation every quarter, or even every year. And lastly, the one that really comes home, again in periods of stress is that we have some confidence in the reliability of the numbers we're looking at. That they were accurately tested in terms of statistical evaluations. They were realistically valued in terms of their collectibility and their working inventory. There are certain areas, such as inventory and receivables, that are consistent sore spots that I become more and more suspect of, especially as we go into a cyclical downturn. [Also included in 17(a)] **[TC 3/11, p. 13]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality. During the discussion, a comment was made on consistency.

Participant C-11
I basically don't like the word conservative at all because it could be misinterpreted in the way that others have just spoken of in terms of "if there's any question make it a very low number and end up having undervalued assets and ineffective reserves". The word realistic or relevant to the situation is more appropriate. And consistency also is important. Consistency of application so that you don't get what I would call artificial, arbitrary swings in numbers because, in this case, they've been valued too low and then something transpired and they had to be written back up or whatever. [Also included in 2(b)] **[TC 3/11, p. 42]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of structure and process. During the discussion, comments were made on qualitative aspects of external reporting.

Committee/Staff/Observer
We have a migration process for change when you make changes gradually over a period of four or five years. What does that do to you as users in terms of comparability? We've heard you say you want ten years restated of information when there is a change and every time you have a change it causes you to have to retrain your people and maybe adapt your systems. How do we solve the preparer resistance by going to a migration problem and create one for you? [Also included in 18(c)] **[TC 3/11, p. 66]**

Participant C-5
Well, some of this is scope. Obviously if you're talking a Fortune 500 company, you apply the standards on almost a consistent basis but I'm talking more scale, size of company issues. We train junior analysts off the senior people so the senior people work the biggest companies. That passes down. You've got your own internal transition process. We don't train somebody

who has a year on the job in the current accounting conventions because they really are irrelevant for the cases they're analyzing. We already accept that fact because we're getting tax returns and we're getting review statements now. We're living with less disclosure and differential statements even though you don't have different standards. [Also included in 18(c)] **[TC 3/11, p. 66]**

Participant C-2
I would like to go back to the idea of differential standards; there may be a very different view in terms of that, particularly for smaller institutions where we may depend on information that's accumulated by trade associations and so forth where they may not screen out who adopts something early or where companies may be in that process. It has the potential to severely disrupt comparability. And that is an important tool that I think has to be considered. [Also included in 18(c)] **[TC 3/11, p. 67]**

Participant C-8
I agree. A lot of smaller end companies are not going to make radical changes and we're going to spend a lot more of our time trying to reanalyze the information and bring it back to being comparable. [Also included in 18(c)] **[TC 3/11, p. 68]**

Participant C-13
I just wanted to respond to what [committee/staff/observer] said about gradual change. We think that the transition periods are too long now. It's going to be 20 years before [two companies'] numbers are comparable because of the decision they made on FAS 106. [Also included in 18(c)] **[TC 3/11, p. 68]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 2

a. Many participants at the December 9, 1992 meeting expressed a preference for disaggregated disclosures that are consistent with the way the company views itself and reports internally. At the same time, participants have emphasized the need for comparability of financial reports among companies, particularly within the same industry. Unfortunately, segmentation based on internal reporting may be inconsistent with better comparability. That is, similar companies with similar operations might provide significantly different disaggregated information solely because their internal organizations differ.

   However, our understanding is that investors would prefer segment reporting consistent with the way the company views itself internally, rather than based on other approaches that would result in more comparable disaggregated information among companies. In other words, in the area of segment reporting, investors assign greater importance to the relevance of

information based on internal reporting than to comparability among companies. Is our understanding correct?

Yes *6* No *1*

Participant I-12: The key is how the company organized itself and conducts operations to generate a return to the shareholder.

If NO, please explain :

Participant I-9: Comparability is more important and lends itself to less management "abuse" or manipulation. The problem is how to sort out companies into industry groups without forming too many or too few. Aluminum companies are homogeneous but retailers cover a broad range - wholesalers, supermarkets, department stores, etc.

b. Do you have suggestions for mitigating the effects on comparability of disaggregation based on the way the company views itself and reports internally?

Participant I-9: This is hard to answer without knowing how internal reports differ from each other. For instance, the [name deleted] reports to Directors years ago were designed to prevent anyne from figuring out how profitable the [name deleted subsidiary] partnership was. It was virtually impossible to reconcile internal financial reports with shareholders financial reports. Perhaps there have to be standards that are generally accepted for internal statements.

Participant I-11: In many cases, I think the differences will be small. In any event, I think the value of "comparability" is overstated- the variations in accounting practices between companies can reduce "comparability" enough to make it of little value.

Participant I-12: Most companies in a given business will tend to organize internal reporting systems in a surprisingly similar fashion - ex. all credit card companies track similar info. because it is inherent in the business. As long as information is disclosed, analysts can make adjustments for major discrepancies.
[Also included in 3(b)] **[PMQI 12/9 and 1/3, p. 3]**

[Context] The paper is a summary of a committee and staff members' discussions with selected sell-side analysts from Bear Stearns:

[One analyst] expressed the following . . . regarding his approach to securities analysis: [Also included in 1(a), 1(b), and 15] **[BEAR STEARNS, p. 1]**

- It is critical that there be consistency in the application of accounting principles, not only for purposes of comparing a company's performance over a period of time, but in comparing a company against other companies in the same industry. For example, the flexibility provided by FASB Statement No. 86 (software costs) allows flexibility in determining the point at which software product development costs should begin to be capitalized. Depending upon the company's approach to software development, a relatively large portion or relatively small portion of software development costs can be

capitalized, resulting in diminished comparability between software companies. (He would prefer that companies expense all software development costs.) [Also included in 1(b) and 15] **[BEAR STEARNS, p. 1-2]**

To improve financial reporting, from an analyst's point of view, [one analyst] recommended . . . the following. . . : [Also included in 1(b), 3(a), 8(d), 15, and 17(d)] **[BEAR STEARNS, p. 2]**

Improve comparability in the use of accounting principles between companies within the same industry. For example, the transition provision in FASB Statement No. 106 (OPEBs) that allows companies to adopt the Statement either by cumulative adjustment or by recording a transition obligation and amortizing that obligation over a long period of time, results in diminished comparability of otherwise similar companies. [Also included in 8(d) and 15] **[BEAR STEARNS, p. 2]**

[Context] For companies in the precious metals business, the Mining Industry Subcommittee of the AIMR Corporate Information Committee would like to see improvements in reporting the following:

- Consistent operating data should be available that can, in some way, be related to reported financial data. [Also included in 15] **[AIMR/CIC91, p. 2]**

Most [CIC] subcommittees agree . . . [that] the following suggestion seems appropriate: [Also included in 1(b), 2(b), 3(b), 3(d), 5(a), 5(d), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3]**

- Quarterly reports with timely data presented in a format comparable to that of the annual report. [Also included in 1(b), 2(b), 11(a), and 16(b)] **[AIMR/CIC92, p. 3]**
- Reports should be prepared under a standard format. Companies that use the metric system should provide appropriate tables for conversion, while companies seeking foreign investors should state appropriate currency exchanges rates. [Also included in 1(b) and 16(b)] **[AIMR/CIC92, p. 3-4]**

Overall, we believe that the FASB is doing a good job. We do, however, have two major concerns:

1. The inconsistency, standard-to-standard, and alternatives within standards, of effective date and transition provisions for new pronouncements;
2. Destruction of financial data without commensurate improvement in the financial information provided. . . .

[Also included in 18(e)] **[AIMR/FAF91, p. 7]**

Objectives of the FASB
Objective 1 [Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and

consistency]. Overall we believe that the FASB has done more to improve the usefulness of financial reporting by focusing on relevance and reliability than it has to improve comparability and consistency. **[AIMR/FAF91, p. 7]**

The diversity of approaches taken to the effective date and transition provisions for new standards has created major problems of comparability and consistency for users of financial statements. Standards having major financial statement impacts have generally been issued with a delayed effective date, although early adoption has been encouraged. Most recent pronouncements could be adopted in any one of three years. However, there was a five-year period before FAS 87 (Pensions) was fully effective for both domestic and foreign plans. This has given companies a choice of years in which to adopt, preventing comparability company-to-company even within an industry. Obviously there is no hope of reasonable comparability of financial statements among industries. **[AIMR/FAF91, p. 8]**

In addition to being able to choose the year in which to adopt, some of the major pronouncements also permit a choice of how to adopt. FAS 91 (Loan Fees), for instance, permits retroactive application or prospective application. The choices under FAS 96 (Deferred Taxes) are numerous and complex. **[AIMR/FAF91, p. 8]**

These problems are not new. Statement No. 13 (Leases) was issued in 1976 but not required until 1981. Statement No. 52 (Foreign Currency Translation) had the more typical three-year choice and permitted, but did not require, restatement. Analysts have always found lack of comparability a nuisance. In the past, however, there were very few pronouncements that had a material impact on virtually every company and these pronouncements were issued years apart. Analysts were generally able, with a little effort, to come to reasonable conclusions about the impact of a new statement on individual companies. **[AIMR/FAF91, p. 8-9]**

Unfortunately, the frequency with which major pronouncements have appeared within the past five years, their complexity, interrelationship, and the ongoing nature of the accounting adjustment has made it almost impossible for the analyst to restate results on a comparable basis for a period of years. **[AIMR/FAF91, p. 9]**

We are not suggesting that the FASB issue fewer pronouncements, which is an unacceptable solution. We have requested that the FASB consider simplifying the procedure for adopting new pronouncements by making them effective for everyone in a single year and prescribing only one method of adoption. **[AIMR/FAF91, p. 9]**

In some cases financial data have been destroyed without commensurate improvement in the financial information provided. Financial analysts generally do not rely on a single year's results to make their decisions. They typically gather information for a long period of time and analyze trends and relationships. (Five years of historical data is common; ten years is preferred. Recognizing the importance of understanding corporate results over more than one business cycle, AIMR's Corporate Information Committee, which annually evaluates the status of corporate reporting, encourages eleven-year financial histories. Some industry subcommittees provide bonus points for twenty-years of historical data.) [Also included in 1(b)] **[AIMR/FAF91, p. 9-10]**

A change in accounting principles destroys the comparability of data before and after the change. Even when the FASB requires restatement it provides analysts with only three comparable income statements and two comparable balance sheets. Occasionally, analysts have sufficient information to estimate the impact on earlier years and are able to restate the results themselves. Some companies take the time to assist analysts to understand the pre- and post-change data. Generally, the ability to analyze trends over a long period is simply destroyed. [Also included in 1(b)] **[AIMR/FAF91, p. 10]**

We do not mean to suggest that the FASB retreat from providing necessary new accounting standards. Prompt action is expected when existing GAAP is inadequate and misleading. **[AIMR/FAF91, p. 10]**

However, we believe that the destruction of financial data is a cost to users of financial statements that should be considered when the FASB makes its decisions about a new standard. If the new standard does not produce significantly better information (more relevant and more reliable), then a new pronouncement should not be implemented. **[AIMR/FAF91, p. 10]**

Many analysts believe that at least three standards adopted within the past five years--(Statements Nos. 94 (Consolidations), 96 (Deferred Taxes), and 97 (Insurance Company Reporting)--do not meet this criterion. **[AIMR/FAF91, p. 10]**

Consolidation (Statement No. 94) theoretically may be the correct answer, but for many users the destruction of the financial data base far exceeds any advantage of having consolidated statements. A few major corporations have understood the problem and are providing separate supplementary financial statements or consolidating financial statements in their annual reports. The user can only hope that more managements will understand the importance of the loss of the disaggregated information and provide it on an annual and quarterly basis. We also encourage the FASB to expedite its review of FAS No. 14, Financial Reporting for Segments of a Business Enterprise. [Also included in 3(c)] **[AIMR/FAF91, p. 11]**

FAS No. 96 (Deferred Taxes) was intended to repair faults evident in the results of applying APB Opinion No. 11. Unfortunately the new standard provides confusing and incomprehensible results equal to that produced by the old. Many users believe that Statement No. 96 does not provide a gain in reliability or relevance that makes up for the cost of the destroyed data. **[AIMR/FAF91, p. 11]**

FAS No. 97 (Long-Duration Contracts of Insurance Enterprises and Realized Gains and Losses from Sale of Investments) requires insurance companies to discontinue their long-standing practice of reporting realized investment gains and losses on a separate line in the income statement below operating income and net of applicable income taxes. Many would agree that this change is theoretically correct. The old presentation, however, provided information about the impact of management's investment decisions on the company's operations. FAS 97 destroyed the analyst's data base without providing information that is more relevant or reliable. **[AIMR/FAF91, p. 11-12]**

Precept 4 [*To bring about needed changes in ways that minimize disruption to the continuity of reporting practice*]. To minimize disruption to the continuity of reporting practice, we believe

that the FASB should eliminate alternatives and establish one effective date for implementation. We discussed the problems inherent in the disruption of the continuity of reporting practice earlier in this response. [Also included in 18(e)] **[AIMR/FAF91, p. 25]**

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(b), 4, 5(a), 5(b), 5(d), and 13] **[KPMG BANK STUDY, p. 39]**

- Generally believed fair value disclosures of financial instruments would be useful provided they were reliable and comparable [Also included in 2(b) and 4] **[KPMG BANK STUDY, p. 39]**

The FASB, the Securities and Exchange Commission (SEC) and other regulatory bodies are currently considering a requirement to prepare financial statements based on market values in place of financial statements prepared on a historical cost accounting basis. The questions in this section relate to this issue: [Also included in 1(b), 2(a), 2(b), 4, 10(b), 11(a), and 15] **[KPMG BANK STUDY, p. A-9]**

- **Indicate whether you believe fair value accounting should be the primary accounting basis for the preparation of an institution's financial statements.**

  10% Yes
  90 No
  0 No opinion
  [Also included in 2(a), 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-9]**

  [One user commented] no. It is difficult to determine the fair value of many assets and liabilities. This could distort financial statements and hinder comparability. [Also included in 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-9]**

  [One user commented] no.
  --Misrepresents "lending to maturity" aspect of bank loans.
  --Concern about behavioral impact on bankers.
  --Costs more to gather information than benefits users.
  --Too much estimation required; comparability and integrity [are] questionable.
  --Misuse of information by less-sophisticated users.
  [Also included in 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-10]**

  - *High degree of subjectivity, and the inherent uncertainty of forecasts on which valuations are based, will diminish both the consistency and comparability of financial institutions' reports.*
    [Also included in 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-10]**

- **There are current accounting rules that require the disclosure of fair values, realized and unrealized gains and losses, cash flow information and maturities and yields of investment securities. Considering that this information is already available, indicate whether you believe the historical cost based accounting should be replaced with fair value based accounting.**

  8% Yes
  88 No
  2 No opinion
  2 No response
  [Also included in 2(a), 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-11]**

  [One user commented no]. Much of the additional information that would be available with fair value accounting must be based on estimates which are likely to incorporate varying assumptions and therefore, is unlikely to be reliable or consistent. Further, much of what is proposed is irrelevant for valuing a banking company. [Also included in 2(a), 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-11]**

- **For an institution that has the intent and ability to hold assets for the foreseeable future (defined as 12 to 18 months), indicate whether you believe fair value accounting is appropriate.**

  30% Yes
  60 No
  8 No opinion
  2 No response
  [Also included in 2(b), 4, 10(b), and 15] **[KPMG BANK STUDY, p. A-13]**

  [One user commented] yes. Some effort at fair value accounting is still useful for these organizations. However, if the subjectivity involved is too great for certain loans so that comparability is destroyed, I would favor historical cost with an explanatory footnote. [Also included in 2(b), 4, and 15] **[KPMG BANK STUDY, p. A-14]**

From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 1(b), 2(d), 3(c) 4, 5(a), 5(c), 6, 8(a), 9, 11(b), 11(c), and 15] **[BETRIOU, p. 1]**

If it is accepted that the existence of options leads accountants to make different choices, the comparison between companies may nevertheless require the elimination of the incidence of these choices. Published data does not always allow for such process. Consequently, IASC's efforts to reduce the number of options seems to us positive. Such an orientation should also be sought at the European level. [Also included in 1(b) and 15] **[BETRIOU, p. 2-3]**

The case of companies modifying their structures is worth mentioning: comparability in time would be greatly improved by the publication of data with a constant structure over three years (two years are often insufficient to determine trends). [Also included in 1(b) and 15] **[BETRIOU, p. 3]**

In consolidated accounts in particular the impact on the profit and loss account, over a full year, for recently consolidated or deconsolidated companies becomes requisite data in order to make estimates. In our opinion this should be published. Alterations in the consolidation circle during the financial year are presently made "pro rata temporis". [Also included in 1(b) and 15] **[BETRIOU, p. 3]**

2.c.27 Consistency vs. Comparability

Another issue that has been much in discussion among the accounting community is whether to give more importance to consistent reporting by an individual company or comparable reporting among companies. The survey sample was asked:

Table 4.9

MORE IMPORTANT: CONSISTENCY OR COMPARABILITY?

Q.13C—The Board seeks to develop neutral standards that result in accounting that reports similar transactions and circumstances similarly and reports different transactions and circumstances differently. Ideally, the reporting of similar transactions and circumstances in the same way would be *both* comparable from company to company and consistent from period to period. In general, . . . if you had to choose, which do you think is more important—consistent reporting by an individual company or comparable reporting among companies?

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	**451**	**78**	**79**	**33**	**28**	**41**	**61**	**45**	**15**	**15**	**15**	**31**	**38**	**17**
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Consistent reporting by an individual company	63	64	58	39	68	68	74	73	73	67	80	71	45	59
Comparable reporting among companies	32	33	34	58	25	27	25	20	20	20	20	23	45	41
Equally important	1	–	3	–	–	–	–	–	–	–	–	–	5	–
Not sure	4	3	5	–	7	5	–	7	7	13	–	6	5	–
No answer	*	–	–	3	–	–	2	–	–	–	–	–	–	–

*Less than .5%.

Observation: *Clearly, the preference is for giving a priority to consistent reporting by an individual company over comparable reporting among companies. The only groups who take exception to this general judgment about importance are CEOs of smaller public companies who want to give a priority to comparability by 58-39% and academics who split down the middle 45-45% on this issue. Financial media opt for consistency but by a closer 59-41%.*

[HARRIS]

2.C.28 By the same token, however, a majority also simply does not see the dangers in the employment of comparability measures:

Table 4.10

DANGER THAT USE OF MORE COMPARABILITY MIGHT BRING SUCH UNIFORMITY IN FINANCIAL REPORTING THAT DISSIMILAR THINGS MIGHT LOOK SIMILAR

Q.13D—It has been said that efforts to bring about more comparability might bring about a degree of uniformity in financial reporting that would make things that are dissimilar look similar. In your view, is this likely to happen?

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Likely to happen	34	38	41	33	32	27	28	29	33	20	33	35	39	24
Unlikely	59	56	58	61	57	66	61	62	53	67	67	55	55	71
Not sure	6	5	1	3	11	7	10	9	13	13	–	10	5	6
No answer	*	–	–	3	–	–	2	–	–	–	–	–	–	–

*Less than .5%.

In addition, when asked directly if they felt there was too much, too little, or about the right amount of emphasis on comparability in financial reporting, there is little mandate for change from current practices.

Table 4.11

AMOUNT OF EMPHASIS ON COMPARABILITY IN FINANCIAL REPORTING

Q.13E—Do you feel today there is too much emphasis on comparability in financial reporting, too little, or the right amount of emphasis?

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Too much	27	37	38	12	25	15	18	31	33	27	33	39	18	12
Too little	28	23	34	36	18	44	23	13	13	7	20	19	34	53
Right amount	40	37	27	42	50	34	52	49	47	53	47	39	39	35
Not sure	4	3	1	6	7	7	5	7	7	13	–	3	8	–
No answer	*	–	–	3	–	–	2	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

2C.29 Finally, those who feel there is too much emphasis as well as those who feel there is too little emphasis on comparability in financial accounting were both asked for examples of what they had in mind:

Table 4.12

EXAMPLES OF CASES OF OVER- OR UNDEREMPHASIS ON COMPARABILITY

BASE: TOTAL RESPONDENTS	Too Much Emphasis 122	Too Little Emphasis 128
	%	%
Pension fund accounting	23	14
Oil and gas accounting	3	9
Inventory accounting	4	22
Lease accounting	7	7
Income tax/tax credit accounting	3	11
Depreciation	4	18
Earnings per share	9	1
Inflation accounting	3	2
Revenue recognition	–	5
Cash flows	–	2
Foreign currency	4	2
Historical cost	–	2
Unlike/dissimilar industries cannot be compared	19	8
Similar business, dissimilar size	7	2
Fixed assets/fixed asset accounting	2	2
Any other mentions	35	37

Observation: *Those who feel there is too much emphasis on comparability in financial reporting tend to feel this is most evident in pension fund accounting, in earnings per share reports, and in efforts to compare dissimilar industries. By the same token, those who feel there is too little emphasis on comparability say this is evident in inventory accounting, depreciation, oil and gas accounting, income tax accounting, and pension fund accounting.*

However, the key fact is that on an overall basis, 27% think there is too much emphasis on comparability but an almost precisely equal 28% who feel there is too little emphasis on comparability. Splitting the middle is a swing 40% who feel there is the right amount of emphasis on comparability. And while more importance is place upon consistency than comparability, nonetheless, both are obviously viewed as essential in financial reporting.

[HARRIS]

2.c.30 Following is a breakdown by respondents citing cases where they believe there is either over- or underemphasis on comparability in financial reporting.

Table 4.13

EXAMPLES OF CASES WHERE THERE IS TOO MUCH EMPHASIS ON COMPARABILITY: BREAKDOWN BY RESPONDENTS

Q.13F-1—Can you give examples of where you believe too much or too little attention is paid to comparability? Base: Too much emphasis on comparability.

		Large Public Companies		Small Public Companies (C.E.O.)	Private Companies (C.E.O.)	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers					Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	122	29	30	4	7	6	11	14	5	4	5	12	7	2
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Pension fund accounting	23	31	40	25	29	17	–	21	20	25	20	–	–	–
Oil and gas accounting	3	3	7	–	–	–	–	7	20	–	–	–	–	–
Inventory accounting	4	–	13	–	–	–	–	7	–	25	–	–	–	–
Lease accounting	7	–	13	–	–	–	9	21	–	–	60	8	–	–
Income tax/tax credit accounting	3	–	–	–	–	17	–	14	40	–	–	–	14	–
Depreciation	4	3	7	–	–	–	–	14	–	50	–	–	–	–
Earnings per share	9	3	10	25	–	17	9	–	–	–	–	8	29	50
Inflation accounting	3	7	3	25	–	–	–	–	–	–	–	–	–	–
Revenue recognition	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Cash flows	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Foreign currency	4	–	7	–	14	17	–	–	–	–	–	–	14	–
Historical cost	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Unlike/dissimilar industries cannot be compared	19	21	20	–	29	17	–	14	–	50	–	25	43	–
Similar business, dissimilar size	7	–	7	25	14	–	–	–	–	–	–	17	29	–
Fixed assets/fixed asset accounting	2	–	–	–	–	–	–	–	–	–	–	8	–	50
Any other mentions	35	38	30	75	43	–	64	29	40	–	40	33	14	50
Don't know/no answer	11	17	10	–	–	33	18	–	–	–	–	8	–	–

[HARRIS]

2.C.31

Table 4.14

EXAMPLES OF CASES WHERE THERE IS TOO LITTLE EMPHASIS ON COMPARABILITY: BREAKDOWN BY RESPONDENTS

Q.13F-2—Can you give examples of where you believe too much or too little attention is paid to comparability? Base: Too little emphasis on comparability.

		Large Public Companies		Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms				Small Accounting Firms	Academics	Financial Media
	Total	Chief Exec. Officers	Chief Financial Officers					Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	128	18	27	12	5	18	14	6	2	1	3	6	13	9
	%	%	%	%	%	%	%	%.	%	%	%	%	%	%
Pension fund accounting	14	28	19	–	20	11	–	17	–	–	33	–	15	22
Oil and gas accounting	9	11	11	17	20	17	7	–	–	–	–	–	–	–
Inventory accounting	22	28	11	17	20	22	7	17	–	–	33	17	62	22
Lease accounting	7	–	11	8	–	6	–	–	–	–	–	33	8	11
Income tax/tax credit accounting	11	22	22	8	20	6	–	–	–	–	–	–	8	–
Depreciation	18	28	19	–	20	17	–	33	50	–	33	17	38	11
Earnings per share	1	6	–	–	–	–	–	–	–	–	–	–	–	–
Inflation accounting	2	–	4	–	–	–	–	–	–	–	–	–	–	11
Revenue recognition	5	6	11	8	–	6	–	17	–	–	33	–	–	–
Cash flows	2	–	–	8	–	6	–	–	–	–	–	–	–	–
Foreign currency	2	–	–	–	–	6	–	–	–	–	–	–	8	11
Historical cost	2	–	–	–	–	–	–	–	–	–	–	–	15	–
Unlike/dissimilar industries cannot be compared	8	–	4	25	20	6	7	–	–	–	–	17	–	22
Similar business, dissimilar size	2	–	–	–	–	–	7	17	50	–	–	–	–	11
Fixed assets/fixed asset accounting	2	–	–	8	–	–	–	–	–	–	–	–	15	–
Any other mentions	37	22	44	42	20	33	36	83	50	100	100	50	23	33
Don't know/ no answer	16	28	7	8	–	11	43	–	–	–	–	17	15	22

[HARRIS]

2(d). Other

The APC [Accounting Policy Committee] is aware that there are costs to financial statement issuers of providing new accounting data or strengthening auditing standards. When new standards are promulgated, those costs should be exceeded by the value of two benefits. First is the potential benefit to individual borrowers of the lower borrowing costs afforded by the reduction in risk associated with reliable and understandable financial information. The second benefit inures to the economy as a whole from improved optimal capital allocation decisions made by well-informed lenders. **[RMA90, p. 2]**

Understandability is an important characteristic of accounting data. The [following item] listed below [is] vital to understandability. **[RMA90, p. 3]**

- Going concern applicability: Financial accounting standards should be promulgated to apply to going concerns, i.e., viable operating enterprises. Enterprises in liquidation, bankruptcy or other financial distress are not susceptible to measurement by the standard accounting model. **[RMA90, p. 3]**

[Fifty-eight] percent of the individual [investors] said annual reports were often too promotional. **[HILL KNOWLTON, p. 6]**

[A Baltimore security analyst said that annual reports are] used as sales tools. **[HILL KNOWLTON, p. 6]**

"The annual report is little more than a piece of advertising." (St. Louis brokerage firm analyst) **[HILL KNOWLTON, p. 7]**

Readability is the subjective evaluation of the degree to which the annual report can be understood by the reader. Readability is not an issue for the professionals. They are comfortable with the language used; the complexity does not impede them; jargon is understandable; financial statements, while complex and not always clear and concise, are not a problem. They have complained, though, that graphs without labels on the axes are useless and that glossy paper can be difficult to read and nearly impossible to write on (which is especially irritating when financial statements are printed on glossy paper). **[SRI, p. 62]**

Individuals find annual reports somewhat less readable than professionals. For them, readability is sometimes a problem, but not a critical one. The financial information in annual reports is the most difficult to understand for most individual investors, but many can master it with effort. **[SRI, p. 62]**

A significant number of both individual investors and professionals state that the appearance of annual reports does influence their views of the company and that it can provide subtle clues. An overly glossy, slick, obviously expensive annual can convey overtones of "hype," of putting on a brave face (for troubled companies), or of wasting the shareholders' money. In

contrast, when the annual is obviously cheaply produced, the impression conveyed is that the company has to pinch pennies, which may be a sign of trouble. **[SRI, p. 62]**

The range of cheap to expensive within which annual reports are expected to fit seems to be subjective. Investors are not specific about their perceptions of expensive and cheap, but they ". . . know them when they see them." A lavish 100th anniversary report or a skimpy turnaround company report would be understandable, but companies whose annuals fall outside that range with no apparent reasons are sometimes perceived to have problems. **[SRI, p. 62]**

Neither individual investors nor professionals say they want less detail in annual reports. Both groups, however, do want reduced complexity and a presentation that facilitates their extracting meaning from annuals. Professionals have the further need to increase the efficiency with which they conduct their investment analyses. **[SRI, p. 63]**

Virtually none of the professional investors is bothered by detail; on the contrary, they want more of it. Even those who do not expect to use all the data presented in an annual report still want access to as much detail as possible. **[SRI, p. 63]**

Individual investors are not so consistent--some find annuals too detailed and too complex, some want more detail, as shown in [the] [below] table. Semiprofessional individuals do not find the detail in annual reports excessive, nor do most of them have difficulty coping with the complexities of the financial data. The buy-and-hold segment is almost evenly split between those who find annuals excessively detailed and those who do not. They are similarly split in their perceptions of the difficulty of the financial data. The opportunity-driven segment has a preponderance of investors who find annual reports neither too detailed not too difficult. **[SRI, p. 63-64]**

Are Annual Reports Too Detailed?

Survey Question	*Buy & Hold*	*Opportunity-Driven*	*Semi-professionals*	*All Individuals*
"Annual reports are too detailed for my needs"				
Agree	42.3%	29.3%	20.9%	36.2%
Disagree	38.5	45.7	57.9	42.8
"The financial data in annual reports are too difficult for me to understand"				
Agree	34.6	18.6	13.7	27.3
Disagree	38.5	52.9	68.0	45.9

Source: SRI International survey, 1986. **[SRI, p. 63]**

Professionals and individuals alike are against creating different versions of the annual report for different audiences. In addition to believing that one group should not be deprived of information given to another group, which is perceived as a form of discrimination, they believe that those receiving more information have an unfair advantage. Even though professionals believe that they would receive the more detailed versions of annuals, and even though some individuals complain of the detail and complexity in annual reports, a majority of both groups opposes differential reporting. [Also included in 5(d) and 15] **[SRI, p. 70]**

When asked to agree to disagree with the statement, "Companies should publish different versions of the annual report for different audiences," investors expressed the following views: [Also included in 5(d) and 15] **[SRI, p. 70]**

	Professional Investors	*Individual Investors*
Agree	22.8%	30.3%
Neutral	6.7	11.6
Disagree	70.5	52.8

[Also included in 2(d), 5(d) and 15] **[SRI, p. 70]**

In 1983, FERF reported on an experiment, which is still underway, exploring the concept of a "summary annual report." It would relieve information overload, while being a more useful, informative communication device for a company's shareholders and for unsophisticated investors. Thus, the summary report would become an abbreviated, efficiently formatted, highly readable successor to today's annual report. Those needing more information would still have access to the SEC Form 10K. [Also included in 5(d) and 15] **[SRI, p. 70]**

This study has shown that those aspects of summary reporting that clarify, summarize, present in more understandable form, and add value to annual report information would be well received, but reducing the amount of information included in the annual report would not be. Many of the suggestions offered for improving the annual report had to do with the need for more information, rather than less, and for information with a higher added value. [Also included in 5(d) and 15] **[SRI, p. 70]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the types of information they use to achieve their objectives, some investors raised several issues related to the qualitative aspects of financial reporting.

Participant I-7
We don't get good FAS 14 disclosure in the annual report and we get less from most of our companies in the quarterly reports. FAS 14 is just an abomination at least in my industry from a quarterly point of view. I also heard the argument about the expense of creating this

information. There isn't a reasonable size company that doesn't have internal reporting and the people inside the company get a report card, if not monthly certainly quarterly, and that's the kind of information that is readily available that I would like to see. One of the things that should be discussed somewhere is: what the information that we as outside investors should not be permitted to get from a competitive point of view? They all know internally what their competitors are doing and yet they don't want to provide certain information to us for competitive reasons. It's vital that the accounting profession decide what kinds of information are competitively harmful and others that aren't. [Also included in 1(b), 3(a), 3(b), 3(d), and 11(c)] **[TI 10/16, p. 21]**

Participant I-11
Another point is the MD&A which usually reads something like this: sales were up because we sold more products at higher prices, cost of goods was up because we paid more for raw materials, and gross profit was down because cost of goods went up more than sales. That's about what you get in 90% of MD&A; that is a farce. Either require management to have meaningful discussion of their operations or get rid of it. [Also included in 1(b) and 13] **[TI 10/16, p. 22]**

Participant I-12
I want to come back to the MD&A. Not only the discussion of the income statement approach is bad, but try to look at the balance sheet. There aren't many people who would have realized the problems that were emerging at [name deleted] on lending businesses unless you looked at their balance sheet from a lender's viewpoint. The MD&A has just been so bad. Companies say the SEC has certain requirements and you can't get your statements out to the SEC in a timely fashion unless you meet their requirements. If you start looking at MD&As across industries, they all read the same way. [Also included in 13] **[TI 10/16, p. 23]**

What I'm starting to see in the subcommittee I run is that companies are beginning to tell you something on why revenues are up, for example. Every year we told them about the inadequacies of their MD&A; it took 4 or 5 years but now they are starting to respond and we're starting to see some improvements. **[TI 10/16, p. 23]**

Participant I-6
I think the formal statements are very important. I include them in my model and I see the % changes. But more importantly, then I read the footnotes and the front of the annual report and I try to reconcile what they say about the company to what the financial statements actually say. Nine out of 10 times, the MD&A doesn't even address what changed in the financial statements. [Also included in 1(b) and 13] **[TI 10/16, p. 27]**

Participant I-9
I was investment manager at [a company's] pension fund for 12 years. The numbers were worked backwards to give a total that looks something reasonable but wouldn't cause problems with the next union negotiations. That the rate of return was not something that the employees would feel we couldn't make, and it was to show that we were about 85% funded because they

wouldn't have any worry that we could pay the pensions. If we showed that we were overfunded, it was an open invitation to take it away from us. It was a case of "what do you have in mind"? The company would have been insolvent if they had taken completed transactions for the number of people that they were going to lay off in the coming years at $50,000 a head. Now, you're seeing companies like [name deleted] claiming they can make 12% investment return on their pension fund. So it's an absolute disgrace. [Also included in 1(b)] **[TI 10/16, p. 29]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on the ways investors use information from external reporting to achieve their objectives, some investors raised the issue of information that should not be disclosed for competitive reasons.

Participant I-7
One of the things that should be discussed among analysts, accountants, and the companies is a list of information that cannot be disclosed for competitive reasons. There are certain things that I believe can competitively hurt a company. **[TI 10/16, p. 54]**

Participant I-5
On the other hand, a company issues the quarterly results and there is a conference call. The quarterly results are 2 pages long and there are analysts on that call for two hours. There is more being discussed on that conference call than what was on that press release. Why doesn't everyone else get to see it? Competitive reasons? I don't think so. Why isn't that printed and available? [Also included in 11(e)] **[TI 10/16, p. 54]**

Participant I-6
We have asked for a long time that the aluminum companies disclose their average realized prices historically. Now they're starting to do it. I don't understand the competitive disadvantage they experience by giving you the historical realized prices of a commodity and yet it took forever to get it out. [Also included in 13] **[TI 10/16, p. 54]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of structure and process. During the discussion, comments were made on the overall quality of external reporting.

Participant I-12
I would agree with [participant I-11]. There has been a visible decline in the quality of financial reporting; companies are far more cautious about how and when they disclose things. Maybe it's better ultimately, I don't know. We have to participate in monthly conference calls; the things that management is willing to talk to us about have changed. We get less of a feel for what's really going on. [Also included in 18(b)] **[TI 3/17, p. 63]**

Committee/Staff/Observer
You're getting less as a result? [Also included in 18(b)] **[TI 3/17, p. 63]**

Participant I-12
Yes. This environment has got to the point that if you have a bad quarter, the shareholders sue you for withholding information. It's being used far more than is reasonable. [Also included in 18(b)] **[TI 3/17, p. 63]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on the overall quality of external reporting.

Participant C-1
One of the problems that we run into between accrual accounting and cash accounting is that accrual accounting now has become so complex, with all the new accounting standards that have been coming out, that it's becoming very difficult for us to go from accrual accounting back to cash accounting. And most of the companies that we see, and most of the bankruptcies that we've worked on, have had very nice income statements, very nice balance sheets, but the problem is that they run out of liquidity. We look more and more at the income statement, the cash flow statement, and the current accounts or the current part of the balance sheet in order to determine liquidity. [Also included in 1(a)] **[TC 12/8, p. 12]**

The other problem we have is that each of the different forms of public information you have all have different information. It's very difficult to go from a proxy statement or from a 10K to a 10Q, and to go back. So the seasonality of cash flow--and that's what really we've found has tripped up most companies is the seasonality of cash flow--is important, but also sometimes very difficult to go back and forth between. [Also included in 1(b)] **[TC 12/8, p. 12]**

Participant C-6
Many times in my business we virtually get no disclosure at all. For example, a balance sheet and income statement with no footnotes. So, it's incumbent upon the lender to go in and query management and dig up pertinent information that we need to make any kind of educated decision. [Also included in 5(d) and 15] **[TC 12/8, p. 27]**

Participant C-3
Increasingly, we're getting into an argument of what's proprietary and what isn't, though, and where do you draw the line between what types of information should users of financial statements have, and what we shouldn't have. So maybe the best way to approach the issue of how do you define a segment is based on revenue volatility, and not individual products or individual legal entities, although I guess the legal entity issue is important. [Also included in 3(b)] **[TC 12/8, p. 32]**

Committee/Staff/Observer
I'd like to ask those who deal with small private companies if you are hearing from those that you loan to, your customers, complaints about the high cost of complying or preparing financial statements under the standards? Everything we're hearing basically is kind of adding to this, and yet one of the reasons that we're here, I think, also is this concept that there is a tremendous cost to the information overload requirements we currently have. Are you hearing from your customers a problem with cost overload? [Also included in 1(b)] **[TC 12/8, p. 42]**

Participant C-7
I deal a lot with small-type companies, revenues under $5 million, and that's an issue that we negotiate with each of our borrowers. Cost of preparation of financial information is a common complaint; they say they can't afford audited financial statements. [Also included in 17(f)] **[TC 12/8, p. 43]**

Participant C-6
I think it's just an ongoing problem there. I'm normally dealing with a compilation or review, and I would love to get an audited statement, but that happens very, very infrequently. But it is a matter of cost, and it's a continual issue with regard to lender or borrower. So that is certainly a consideration, no question. [Also included in 17(e)] **[TC 12/8, p. 43]**

Participant C-5
We are typically getting an income statement and a balance sheet, we are not getting a statement of cash flows, or we're not getting a statement of capital changes. What concerns us is the need to establish some standards for the degree of verification that might go on. Rather than asking for more disclosure, we would trade that for some verification at that level, an audit verification. [Also included in 1(b) and 17(b)] **[TC 12/8, p. 43]**

Participant C-8
We've often done the opposite, and agreed to forego the verification for more disclosure, more schedules of the various assets and liabilities on the balance sheet. [Also included in 1(b) and 17(b)] **[TC 12/8, p. 43]**

Participant C-12
I was going to say I like to look through a full cycle, and today that tends to work out to a decade or more. And unfortunately I end up looking at three to five years often because that's what I'm given, but if I look at three years for a really extensive credit exposure, I'm looking at one small leg of the cycle. And it's not enough. It's a mistake that I think a lot of people I work with and I fall into because we don't have more readily available. It's one area where I think Europeans do a better job than we do. A lot of European companies will routinely put a decade of results in the annual report, and you can see that development over a full cycle. [Also included in 1(b)] **[TC 12/8, p. 49]**

Participant C-3[Participant C-1], in the area of contingent liabilities, especially environmental, are you suggesting that the current FAS 5 rules aren't being followed, or aren't stringent enough? [Also included in 1(b)] **[TC 12/8, p. 55]**

Participant C-1
For example, I've got a company that's in a superfund site with a very impoverished little city, and the reality is the company is going to have to end up even picking up their costs. And the number is just really not disclosed anyplace. [Also included in 1(b)] **[TC 12/8, p. 56]**

Participant C-3
The reason I asked that question is this is an area where you currently have some accounting rules that govern not only the accounting but the disclosure, which is kind of different from some of the other issues that we've been talking about where there aren't any rules or any requirements. I'm not sure if this is an audit issue, or an SEC issue for a public company. [Also included in 1(b) and 17(a)] **[TC 12/8, p. 56]**

Participant C-11
It's judgment, isn't it? So it's a question of not just the management but the auditors having to make a judgment as to materiality, and being pro-disclosure. And oftentimes people aren't pro-disclosure if it's bad. So it's a problem. [Also included in 1(b) and 17(a)] **[TC 12/8, p. 56]**

Participant C-1
I think in a way both these comments refer to an issue that we all wrestle with, which is the quality of financial statements. In no place in the financial statements there is a ranking of the quality of the information which management and accountants rely upon in order to generate the financial statements. [Also included in 1(b)] **[TC 12/8, p. 58]**

Participant C-6
That's a very good point. We've run into a couple of situations where we've asked for information that we weren't able to obtain because management wasn't able to put it together for us. That was a very telling sign as far as management information systems in place and management itself. [Also included in 1(b)] **[TC 12/8, p. 58]**

Participant C-10
When you get on a bankruptcy committee, you can compel information. But the company is paying for it at that point, and in effect the lender is starting to become the equity holder. There is a cost that the company at that point has to incur. [Also included in 1(b)] **[TC 12/8, p. 59]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of display. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-2
I would say users do have a need for that information and generally will get it. But I think it would be very helpful that some of these things would be readily available as part of financial

statements. Particularly some information about the quality of receivables, the agings of payables and receivables. Also the nature of slow moving or obsolete inventory, if that could be disclosed. I think also for businesses that are highly seasonal, if you could give some indication of high/low average receivables, payables, or inventory levels, that would be helpful information. Yes, you do have to get it to do your underwriting. Some of that will already be available to you. I worry a little bit about companies' willingness to disclose some of these. They consider it to be proprietary. [Also included in 5(b)] **[TC 2/2, p. 18]**

Participant C-5
I am a strong proponent of getting cash flow information in a different format than we currently get it. I didn't hear anybody suggest at the last meeting a full cash income statement. But it sounds like a nice proposal. I need more and a better format for cash flow; in a comparable income statement format on a cash basis would be probably the only way to do it. Then the question is again, cost. And I've got to be fair to the borrowers who I've worked with that "am I demanding too much?" and "is there a cheaper way to get it?" I wouldn't expect it to be a high cost approach to the problem. It clearly would be a satisfactory approach. We still are going to end up converting statements prepared under the indirect method to the direct method. We start with the EBIT line and work our way down to a OCF type of number (operating cash flow) which is prior to working capital changes, then a supplemental analysis of the effects of working capital changes on cash flow ultimately coming to a cash from operations. And then working into our understanding of the demands on cash flow, that being interest and fixed charges, what we consider investing, financing activities. Where we end up with cash flow, I think we understand it well, but it's just we have to do a lot of work. [Also included in 5(c)] **[TC 2/2, p. 22]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of disclosure about operating opportunities and risks. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-14
My guess is a lot of this gets on to the competitive information areas that managements are going to be reluctant on disclosing. I think rightfully so. I'm just not clear, I think, on what the objective for this section is. [Also included in 10(b)] **[TC 2/2, p. 32]**

Participant C-17
In today's world, there is a different standard of disclosure for public and private companies. What I'm sensing is, one of the concerns I have is if you try to impose on privately held company, the same level of disclosure, even get close to that you're now requiring of a public company, you're just simply going to drive them away. That's all there is to it. One of the reasons they're private is because they don't have to do all this stuff. [Also included in 10(c)] **[TC 2/2, p. 34]**

Participant C-2
The overriding issue to me is cost. I think frequently we just don't have an idea of how much it costs to do all of this. And it might be helpful to us if we knew because then we could make better judgment. [Also included in 10(c)] **[TC 2/2, p. 34]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-14
I was going to try to differentiate off balance sheet items like swaps and hedges that we talked about in other meetings, because I think we've suggested that there may be better ways to account for them in the financial statements, to present them differently. I distinguish that from things like legal and environmental contingencies where I see a real challenge on the part of the auditors. My understanding is that companies don't want to disclose that kind of information because it helps set up the case for the people coming against the company. I don't know what the answers are but I see that as a more difficult issue to handle than other off balance sheet items. [Also included in 17(b) and 19] **[TC 3/11, p. 7]**

Participant C-7
Looking at the market we service, similar to [participant C-6], we're talking smaller companies. We're seeing I'd say a migration in types of financial reporting, from audits to reviews, reviews to compilations, because of costs. Our concern is in trying to build the perfect machine, you don't consider the market, and the cost benefit of what you are trying to impose. Now for a Fortune 500 publicly trading company, given their size, it's easy for them to bear that expense. When you start getting into, let's say the owner-manager-type companies, I'm concerned about the costs that you're imposing and that instead of improving financial reporting, you're going to have unintended costs by creating all these standards and you're going to impair financial reporting at the lowest level. [Also included in 17(a) and 17(e)] **[TC 3/11, p. 16]**

Committee/Staff/
Would you want an MD&A for private and smaller companies? [Also included in 13 and 17(b)] **[TC 3/11, p. 25]**

Participant C-5
I'd obviously like to start moving down in the middle market segment with more MD&A, even if they are LBO-type companies, where we don't have a public reporting requirement. But, at the same time, I would prefer to know that the auditor feels that there is that obligation associated with the MD&A, by not being able to disclaim any obligation with regard to that, even though they've done work around it. [Also included in 13 and 17(b)] **[TC 3/11, p. 25]**

Participant C-1
What smaller companies say is we'll give you 10K and 10Q equivalents. And all it is, is the balance sheet, the income statement and maybe, if you're lucky, they give you notes. And they claim that that's the 10Q or 10K equivalent. It's not done timely. **[TC 3/11, p. 26]**

Participant C-17
If you try to make the MD&A a tool to be used down at the private sector, I think we're just not going to get anything near what we get from them on the public side, and you're basically going to make a lot of privately-owned companies walk away. So, to expand it beyond what it already is today, you'd get very little at a very great cost. [Also included in 13] **[TC 3/11, p. 26]**

Committee/Staff/Observer
You would make smaller companies walk away? **[TC 3/11, p. 26]**

Participant C-17
I'm just saying that they're not going to be willing to bear the cost of doing it. I wouldn't. If I were running a privately-owned company, it would serve no useful purpose in my mind. **[TC 3/11, p. 26]**

Committee/Staff/Observer
That means that you are willing to grant financing without it? **[TC 3/11, p. 26]**

Participant C-17
We do, don't we? **[TC 3/11, p. 26]**

Participant C-10
There's a rule 15 that the SEC has that requires companies with 300 security holders or more to file a disclosure. Some of the companies that have issued bonds and have let's say 15 holders, have filed that form and said: "Okay, we're no longer going to give it to you." And that has been a very big bone of contention in that area. I would love to see it corrected through the SEC in some way. Companies have deliberately withdrawn the information and they're some of the ones that have then gone into bankruptcy a year or two later. **[TC 3/11, p. 26-27]**

Participant C-7
For the type of company we deal with, getting that kind of information is basically a matter of the credit negotiation process. We should be in there asking these questions of management. **[TC 3/11, p. 27]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of structure and process. During the discussion, comments were made on qualitative aspects of external reporting.

Participant C-14
Management may have the opinion that more disclosures and more information is against their competitive advantage. For example, in the case of legal liabilities, I know they don't even like to tell us numbers in confidence because once they do that, they set themselves up for that number being used by whoever's trying to sue them. [Also included in 18(c)] **[TC 3/11, p. 65]**

Participant C-5
The resistance will come from management due to cost factors. The transitional procedures will be important. For example, you could have differential standards and then a migration procedure over a period of time that would initially establish a goal, would establish interim disclosure procedures or a standard at a midpoint. By using the differential standard framework for private companies, small companies, negotiated lenders, private transactions, by having some different disclosure standards what you really are doing is not changing the standards but you're forcing certain populations to migrate as they grow. That would be one possibility. The other is over the passage of time you might cut the thresholds and force people to migrate accordingly. The other aspect is this concept of levels of assurance associated with the disclosures. I can accept less assurance on certain items. And that hopefully obviously would translate into cost; less assurance, less liability, therefore less cost if we assume that the big component of this is the litigation issue. We hear all the time about the small end borrower shifting to review, shifting to compilation. They are using a migration already and they're transitioning backwards. [Also included in 18(b) and 18(c)] **[TC 3/11, p. 65-66]**

Participant C-10
In terms of resistance to reporting, preparers don't want to disclose more because of competitive information content. Even the lawyers when they have a road show say they can't leave the slides. Or they'll leave the slides, copies of the slides with four of the key pages left out and so all the analysts are sitting there writing as fast as they can when those pages are flashed on the screen. The point I'm making here is I think the companies hide behind this thing and it's not anywhere near as major an issue as they would like to make it sound. [Also included in 18(c)] **[TC 3/11, p. 68]**

2(d). **Other–Page 13**

The quality and usefulness of the information available to the public is an integral part of the analysis of a financial institution's performance and of its estimated value. The questions in this section address the usefulness of the existing financial information and [analysts'] views toward enhancing such information: [Also included in 1(b), 2(a), 4, and 15] **[KPMG BANK STUDY, p. A-3]**

- **Indicate the adequacy of the following current financial statement disclosures.**

	Adequate	Inadequate	Not Applicable/ No Response
Net interest spread	93%	5%	2
Regulatory capital adequacy	85	13	2
Liquidity	65	30	5
Interest rate management	40	58	2
Credit quality	38	60	2
Investment portfolio maturities	75	15	10
Investment portfolio yields	85	5	10
Unrealized gain and loss disclosures	60	35	5
Loan concentration	35	63	2
Contractual loan maturities	60	25	15
Fixed vs. variable rate loan information	63	25	12
Loan portfolio yields	78	15	7
Non-accrual, past due and restructured loans	63	35	2
Other potential problem loans	3	95	2
Charge-off and recovery experience	65	30	5
Allocation of allowance by loan type	43	53	4
Deposit mix	83	10	7
Off-balance-sheet instruments	23	75	2
Five-year summary date	85	13	2
Other	3	8	

[KPMG BANK STUDY, p. A-4]

From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 1(b), 2(c), 3(c), 4, 5(a), 5(c), 6, 8(a), 9, 11(b), 11(c), and 15] **[BETRIOU, p. 1]**

Data relating to one period must be made available as soon as possible to [foreign] financial analysts so they may draw up estimates for the following period. [Also included in 15] **[BETRIOU, p. 1-2]**

Too many groups await the regulatory deadline to issue compulsory data. It may, in particular, come from the fact that data is now available (greater rapidity within groups would ease decision-making) but also sometimes because data is retained (in order to avoid giving data to competition). [Also included in 15] **[BETRIOU, p. 2]**

If accounting data should be complete, using it should nonetheless remain as simple as possible. [Also included in 15] **[BETRIOU, p. 2]**

The fact that appendixes exist should not justify a large diversity in presentations, even if data is published in the end. [Foreign] financial analysts must, in fact, react rapidly. Data which would be stifled in bulky appendixes may very well be partly lost. [Also included in 15] **[BETRIOU, p. 2]**

It therefore seems more advisable to have less possibilities in presentations. [Also included in 15] **[BETRIOU, p. 2]**

3. Disaggregated Information

Data Base Code		Data Base Code	
SRI	■	S&P	□
RMA90	■	BETRIOU	■
RMA92	□	R.G. ASSOCIATES	□
FASOversight	■	HARRIS	□
AIMR/CIC90	□	TI 10/16	■
AIMR/CIC91	■	PMQI 10/16	□
AIMR/CIC92	■	TI 12/9	■
AIMR/FAF91	■	PMQI 12/9 and 1/13	■
AIMR FIN SER INDUSTRY	□	TI 1/13	■
AIMR/FAPC92	■	TI 3/17	■
LYNCH	□	PMQI 3/17	■
KPMG BANK STUDY	■	TC 12/8	■
BEAR STEARNS	■	PMQC 12/8	■
GOLDMAN	■	TC 2/2	□
FREEDMAN	■	PMQC 2/2	□
PREVITS	■	TC 3/11	■
HILL KNOWLTON	■	PMQC 3/11	□
TOWERS PERRIN	□	TMKT 4/7	□

Database of Materials on Users' Needs for Information

3(a). Compliance and Criticisms of Statement 14

Seventy-six percent of the professional investor sample said that annual reports all too often fail to display segment numbers prominently and clearly. (While the SEC requires business segment reporting, companies can emphasize or de-emphasize this information to the extent they wish, including relegating it to a financial footnote near the back of the report.) **[HILL KNOWLTON, p. 9-10]**

In their comments, professional [investors] . . . said that they are interested in long-range forecasts by segment, and that they feel companies sometimes manipulate segment data to obscure, rather than inform: [Also included in 3(e) and 12] **[HILL KNOWLTON, p. 10]**

- "A line-of-business breakdown should be as meaningful as possible, and very detailed. But sometimes, it appears that a company is deliberately trying to muddy the waters when it mixes apples with oranges and gives so much detail that the numbers become meaningless." (Chicago insurance group analyst) **[HILL KNOWLTON, p. 10]**

- "I want clearer breakdowns by segments and explanations of business performance by segments. The more the better. (Boston insurance group analyst) **[HILL KNOWLTON, p. 10]**

- "Annual reports have poor segment data, and are jumbled and confusing." (Boston mutual fund analyst) **[HILL KNOWLTON, p. 10]**

[Investors have observed] that business segment information is often (some said usually) poorly reported. Either important details are omitted, or the business segments reported do not coincide with the way the business is actually conducted. **[SRI, p. 56]**

[Context] The following brief summary of the topic "Disaggregated Financial Statements," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Analysis of a complex economic entity requires information about the workings of each of its components. There is no disagreement among financial analysts that segment information is totally vital to their work. There also is general agreement among analysts that the current segment reporting standard, ***FAS 14***, is inadequate. Recent work by a subcommittee of the FAPC has confirmed that a substantial majority of analysts seek and, when it is available, use quarterly segment data. [Also included in 3(b) and 3(c)] **[AIMR/FAPC92, p. ix]**

The FASB recently initiated a project on disaggregation for which AIMR is providing partial financial support in addition to its overall endorsement. We do not wish to prejudge the results of research now in its initial stage, but we do suggest an avenue for the FASB's researcher to explore. We believe that segment data are most useful when they depict the way in which the enterprise itself is organized and managed and we urge the FASB to seek ways to

promulgate a standard that produces such a result, despite the several difficulties in doing so that we acknowledge and discuss in the report. [Also included in 3(b) and 3(c)] **[AIMR/FAPC92, p. ix]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

Financial analysts have consistently over the years requested financial statement data disaggregated to a much greater degree than it is now. Most analysts have found the provisions of 1976's Statement of Financial Accounting Standards No. 14, "Financial Reporting for Segments of a Business Enterprise," helpful but inadequate. This situation has been exacerbated by the issuance in 1987 of Statement of Financial Accounting Standards No. 94, "Consolidation of All Majority-Owned Subsidiaries." That statement has the good effect of presenting an overall report on complex economic entities and brings onto the consolidated balance sheet a large amount of debt that previously had not appeared there. Its cost has been the loss of much detailed information about subsidiary operations quite different in character from those of the parent company. [Also included 3(c)] **[AIMR/FAPC92, p. 39]**

Reporting How the Business is Managed

FAS 14 requires disclosure of line of business information classified by "industry segment." Its definition of "segment" is necessarily imprecise and it recognizes that there are numerous practical problems in applying that definition to different business entities operating under disparate circumstances. That weakness in *FAS 14* has been exploited by many enterprises to suit their own financial reporting purposes. As a result, we have seen one of the ten largest firms in the country report all of its operations as being in a single very broadly defined industry segment. At the other extreme, there is a publicly-owned provider of funeral services that reports in three segments: funeral services, caskets and other merchandise sales, and cemetery operations. We also are aware of and sympathetic with the problems some enterprises have in collecting and reporting data that conform to *FAS 14* categories because their businesses are organized and managed differently. [Also included in 3(c)] **[AIMR/FAPC92, p. 40]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the preliminary discussion on the objectives and approaches of investors and the types of information they use, some investors commented on the deficiencies of the current disclosures of disaggregated information.

Participant I-6

As a fundamental analyst, I try to forecast earnings. In order to forecast earnings, you have to have a basic understanding of what the company is doing and how it does it. That includes an understanding of the product and the market for the product and, basically, when you look at financial reports, the only thing they tell you is a bunch of numbers that are financial related, but it would help if we knew what the quantity was of what the company produces. There is

also a lack of compliance with FAS 14 on segment disclosures. So when we try to forecast earnings and we don't know the quantity of products the company produces, it's very hard to really forecast those earnings. [Also included in 1(a) and 13] **[TI 10/16, p. 3]**

Participant I-7
Within our organization, there are probably 100 analysts. For the most part, we are very industry specific. [Participant I-6] will follow metal companies, I will follow electrical equipment companies, such as [names deleted] and the likes. One of my primary functions is to directly influence the buy, hold, sell investment decision-making policies on companies in my industry. Within that context, if I had to focus on one single element that is extremely crucial, it's earnings. I also agree with [participant I-6], there is a FAS 14 on the books which for the most part is useless. Either the companies are dismissing it or using it to show how they would like to be viewed from an external point of view, but I would like to see a company the way it looks at itself from an internal point of view. Most of the FASB presentations absolutely don't do that. [Also included in 1(a)] **[TI 10/16, p. 3]**

Participant I-12
Segment reporting is something that is absolutely critical to an analyst. For example, for [a large, diverse financial institution], the cash flows generated by the credit card business have entirely different sources and uses than the cash flows generated by the securities business. It's very difficult from what we see to find that out and find a base from which we can forecast. [Also included in 1(a) and 3(b)] **[TI 10/16, p. 4]**

Participant I-7
I head a subcomittee that looks at investor information in the electrical equipment industry. The disseminated information is very uneven. A major effort was made over the last 5 years to get some consistency in FAS 14 reporting; probably 75% of my companies do not report sufficiently on a FAS 14 basis. The other point that is absolutely critical is giving out meaningful industry information. In the more mature industries, you can get government statistics, but in a lot of cases, those statistics are 12 to 24 months old in time. If I can get some consistency in reporting in the annual report on industry information, that is, total statistics, growth by segments, and market share, the truthfulness of that information can be checked by playing one company off against another. That information is very critical. [Also included in 1(b) and 13] **[TI 10/16, p. 20-21]**

Participant I-12
I head a subcommittee for the AIMR reporting on financial services. What I find interesting going through that exercise every year is that, if you have a diversified financial company like [names deleted], those companies do not report segment data that is comparable to the rest of that particular industry. It has started to get better but the companies are concerned with the cost of preparing that data. But yet, you know they already have the data, they just don't want to publish it. It's really important that when they publish segment data that it bears some resemblance to the industry data in which that segment is competing. [Also included in 3(b)] **[TI 10/16, p. 21]**

Participant I-7
We don't get good FAS 14 disclosure in the annual report and we get less from most of our companies in the quarterly reports. FAS 14 is just an abomination at least in my industry from a quarterly point of view. I also heard the argument about the expense of creating this information. There isn't a reasonable size company that doesn't have internal reporting and the people inside the company get a report card, if not monthly certainly quarterly, and that's the kind of information that is readily available that I would like to see. One of the things that should be discussed somewhere is: what the information that we as outside investors should not be permitted to get from a competitive point of view? They all know internally what their competitors are doing and yet they don't want to provide certain information to us for competitive reasons. It's vital that the accounting profession decide what kinds of information are competitively harmful and others that aren't. [Also included in 1(b), 2(d), 3(b), 3(d), and 11(c)] **[TI 10/16, p. 21]**

Participant I-11
I join the chorus on segment accounting. We could do with much more consistent and detailed segment accounting on a quarterly basis. At least two diversified companies that I know establish the segments they report in a manner totally separate from the method in which they run their business and it's clear they're just trying to obfuscate things. I can't find any justification for that. [Also included in 1(b), 3(c), and 3(d)] **[TI 10/16, p. 22]**

Participant I-8
I follow companies that are in technology areas and they almost all assess they are in one industry. They don't give even a lousy segment reporting, they don't give you any. I met somebody who worked for [name deleted] 4 or 5 years ago who commented that at one point in time, they made 300% of their profit in 3 factories that produce mainframes and every one of the other (I don't know if they had 50 or 100 factories) all lost money. I would wager that in none of the [name deleted] reports did anything like that was ever disclosed. All the financial reporting didn't give anybody an idea of how vulnerable even [name deleted] was to something happening to their mainframe business. **[TI 10/16, p. 22]**

Participant I-1
But if you end up with every company saying they're making 80% of their money with 20% of their products, it would become as meaningless as the MD&A. **[TI 10/16, p. 22]**

Participant I-8
There's a lot of companies that don't even try, but there are a lot of differences between companies that say they're in one business. **[TI 10/16, p. 23]**

Participant I-3
I agree that segment reporting is not as good as it should be and should be improved. But a lot of companies will resist that for a variety of reasons, and in some cases it is because they themselves don't know what is critical to their own businesses. The analyst's job is to find out what is critical. Disclosure will always be somewhat disatisfying because it will never be full. When a company is witholding information from me, there are plenty of other entities that I can focus on; I don't need to have a strong opinion on all of them. I just need to have an accurate opinion about a few of them. [Also included in 1(b)] **[TI 10/16, p. 24]**

Participant I-8
Part of this will be the result of the pressure that the AICPA can bring on management to make more disclosures. The most common argument for limiting segment disclosures is the fear of competitive disadvantage. A company that I have been following for a long time in Long Island and that has a sensational record of growth have been providing for a long time very detailed market share information, including what they thought their competitors' shares are, and it hasn't been a disadvantage to them. I would argue that additional disclosure doesn't hurt. [Also included in 1(b) and 13] **[TI 10/16, p. 25-26]**

Participant I-6
I really appreciate the interest of the accounting community to sollicit us on what additional information we want but there is a number of us in this room that would really like to see the more rigorous enforcement of existing disclosures that are already required. It would be a lot more helpful to us if FAS 14 disclosures were implemented across the board. **[TI 10/16, p. 57]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information.

Committee/Staff/Observer
At our first meeting, most of you mentioned that the aspect of financial reporting most in need of improvement is segment reporting. Our first 7 questions relate to that topic. Some of you told us that part of the problem with segment reporting is that some companies do not comply with either the letter or the spirit of the current reporting requirements contained in FASB 14. We are interested in knowing whether you agree with that complaint. And for those of you who agree, please help us understand in which ways the companies fail to comply with the rules. **[TI 12/9, p. 2]**

Participant I-7
I brought some materials along. I will give you two examples, one on [one company] and the other on [another company]. First, there is a three-page summary headed [latter company name]. In the annual report, what you will see is a breakdown between consumer, commercial and industrial, government and defense, and occasionally an eliminations account. This is close to an $8 billion company. On the next page, what you will see is some 34 years of following the company, trying to keep track of well over 100 acquisitions. If you look at the different groups, particularly commercial and industrial, you will see a group that does some $6 billion in volume and with 15-20 units that will range in size anywhere from $60 million up to close to $1 billion. Aside from the difference in terms of volume within the group, there is a wide disparity in terms of product and market. For example, for [name deleted], which is close to a $1 billion entity, over 50% of its business is done outside the US and it is a leader in the process control business. That is one example of what one has to deal with in terms of FASB 14 where the only information one gets is once a year in a very aggregated format (as shown on the first page). **[TI 12/9, p. 2]**

The other example in the materials is a FASB 14 attempt at a breakout by [name deleted]. If you look at 1991, there is a group category called industries. (This is another company that doesn't report breakouts on a quarterly basis.) Housed within this business is a wholesale electrical distributor called [name deleted] that does something approaching $1.7 billion. If one had not followed the company for a long period of time and made a lot of field visits, it turns out that over 50% of the volume in this business is done by that enterprise and that enterprise, in a good year, does 2.5% in terms of operating profit. **[TI 12/9, p. 2-3]**

Participant I-4
[Participant I-7], on the [name deleted] report, the estimates on the second and third pages are your work, not [name deleted's]. **[TI 12/9, p. 3]**

Participant I-7
Yes. The company gives you some order of magnitude. For the smaller segments, you will try to find out if you're in the $50 to $75 million area; by the time you get to a larger enterprise, they'll put you within maybe $100 million. **[TI 12/9, p. 3]**

Committee/Staff/Observer
There's no way I can follow up that discussion without getting into the second question. What is wrong with FASB 14 and what would you like to see changed? **[TI 12/9, p. 3]**

Participant I-7
First of all, the guidelines are much too broad. The guidelines currently allow major companies in the US to provide the kind of vague information I talked about earlier. Secondly, the information is based solely on the sale side of the business. The reason I brought up the [one company] example and the [another company] business is to show you that, if you're going to do FASB 14 disclosure, on occasion the profit element is much more important in terms of giving a sense of where the business lies and what markets it serves. Again in this company, there are businesses that do over 30% margins that will distort the totals from a sales point of view. **[TI 12/9, p. 3]**

Participant I-6
In line with that comment on loose guidelines, I believe that FASB 14 suggests that if there is a seasonal pattern to sales it should be broken out. Two companies I can think of right away, one makes aluminum cans, the other propane cylinders, do something like 60% of their business in one quarter; yet, they don't give you any seasonal breakouts on the sales or profitability because they say they spread it over the year. So the guidelines for implementation of the accounting standard is the weakness, not necessarily the actual standard. **[TI 12/9, p. 3-4]**

Participant I-12
I like to raise a point that may be specific to financial companies and that is the notion of gross interest income versus net interest income. Using [name deleted] as an example, every year in the Chairman's letter, they tell us they have two major businesses: processing and clearing and the securities business. The whole text of the annual report is built around those two businesses. If you go to the numbers, you can find zero numbers that tell you anything about

the processing and clearing business. One of the ways they get around FASB 14 is by defining revenues on a gross interest basis. If you have a balance sheet of $10, $20, $100 billion and 25% of it in overnight repos, you have a very large dollar amount of gross interest income. That is a distortion. [Two companies] do the same thing (defining segments in terms of gross interest income) thereby avoiding showing the differences between their commercial banking lending business and their newer businesses that are more investment banking oriented. It is interesting that [Participant I-7] handed out something on [name deleted]; I would ask you to look at the [name deleted's] financial services disclosure and tell me if there is any indication that they have massive balance sheet risk in lending. **[TI 12/9, p. 4]**

Committee/Staff/Observer
Is there anybody here for which FASB 14 is not an issue? Everybody feels that there is some problem with FASB 14? **[TI 12/9, p. 4]**

Participant I-7
I have had some discussions about this with my peers. If you are a store chain that is predominantly in the Northeast, I haven't heard our retail person complain about FASB 14. But I would also suggest to you that there aren't too many of those. **[TI 12/9, p. 4]**

Committee/Staff/Observer
Is it compliance with it or the way the standard is written? **[TI 12/9, p. 4]**

Participant I-8
I can't give you specific examples but there might be one company that will honor the spirit of FASB 14 and, although it might be 100% in the electronics business, it will recognize that there are differences within that business. Another company will not honor the spirit of FASB 14 and will make the statement that they are only in one industry, the electronics business, even though they may have three disparate segments. **[TI 12/9, p. 5]**

Participant I-7
The guidelines have to be tightened up and there has to be additions to the guidelines. For example, where you have a series of businesses where 20% of the sales or earnings of the business comes from a specific unit within the total, that should be shown separately. You can then move on from that point to make FASB 14 more informational than it currently is. [Also included in 3(b)] **[TI 12/9, p. 5]**

Participant I-6
I would go further and lower the 20% to 15% because if a company has 10-15 units, it is hard to get a 20% unit; the 20% would only apply if you have a few dominant units. [Also included in 3(b)] **[TI 12/9, p. 5]**

Participant I-4
We don't normally deal with companies the size of [one company] with this many disparate operations, or [another company]. But it is clear that in the companies that we see, that when you begin to discuss their operations by looking at segmented earnings and sales information out of the 10-K or the annual report, they look at you dumbfounded because by and large they aren't running their businesses this way. They aren't reflecting the businesses internally this

way and, in a lot of cases, this kind of work goes a fair way to obfuscate businesses that either are not doing terribly well, or absorbing too much capital or losing money, or businesses that for competitive reasons are doing too well. It is very unclear looking at this information that you can really get a sense of how the firm is being managed. **[TI 12/9, p. 5]**

Participant I-8
A lot of times I will look at segment reporting, and then I will ask for an organization chart because the way the company is organized and the way the different businesses are grouped do not resemble at all what is presented in the annual report. **[TI 12/9, p. 6]**

Participant I-7
The answer is relatively easy. I want a company to report to me the way they report internally. I don't want to spend months or years trying to understand that. [Also included in 3(b)] **[TI 12/9, p. 6]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of disclosure about operating opportunities and risks. During the discussion, an investor made a comment related to his previous criticism of current segment reporting.

Participant I-7
You all know what we think of the information coming out of FASB 14. Consequently, I'm not sure that we would be getting anything better setting up an FASB pronouncement relative to an MD&A than we get with FASB 14. But anything is better than what we have now, so go for it. [Also included in 10(b) and 13] **[TI 1/13, p. 50]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of structure and process. During the discussion, a comment was made on segment reporting.

Participant I-7
There is one body and one body only [for ensuring wide acceptance of the Special Committee's final recommendations] and that is the SEC. I headed one of the AIMR's subcommittee for over 20 years, and 18 of those 20 years we have been going after better segment reporting; in fact, no company could get an award if they didn't report under FAS 14. But the SEC did not put any teeth in the group in terms of forcing the requirement and there just wasn't any change. If you're going to try implementing change, you're going to need the SEC. [Also included in 18(c)] **[TI 3/17, p. 65]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of disaggregated information.

Participant C-1
Segment information is probably the most difficult information to get. One of the key examples is [name deleted] with [its] credit; they were required to consolidate that and they did, and all of a sudden when they ended up selling it, people began to realize it was such a significant part of cash flow. You can break segments down any way you want (for example, foreign versus domestic) and the ability to look at earnings and cash flow on either one, or different lines of business. It's very hard to look at segment information. [Also included in 1(b)] **[TC 12/8, p. 18]**

Participant C-13
I'd back that up. I'm sure you're going to hear the same thing or have the same thing from the equity side. The quality of segment information that's presently being provided isn't adequate. There are far too many changes in definitions, there are far too broad definitions of materiality. There needs to be a great deal more discipline in terms of segment definition, materiality, and the quality of segment reporting. **[TC 12/8, p. 18]**

Participant C-9
Regarding financial institutions, under the segment and the current reporting guidelines for segments, a bank is a bank, and that's one segment, so you don't get any breakdown at all. And so I guess I'd go for segments of segments to get an idea of the viability of the underlying businesses within any institution. **[TC 12/8, p. 18]**

Participant C-3
I think the way financial institutions have looked at the current segment reporting rules is that if I service a certain customer and provide different types of services to that customer, it's one segment, because it's one customer. And I wonder whether the rules ought to be geared to the types of services that are being provided and the types of revenues that are being generated. [Also included in 3(b)] **[TC 12/8, p. 18]**

Participant C-12
I don't have a good answer, but the information could be broken down by management reporting categories. That's ironic that when we look at a finance company report or a bank report, they're in one line of business; but if you talk to them, you talk to a half a dozen people, and they tell you about the different discrete businesses they are in. They're already preparing that information. [Also included in 3(b)] **[TC 12/8, p. 18-19]**

Participant C-4
One problem with segment reporting is that a lot of the companies that are required to report on a segment basis don't report internally on that basis. If we could somehow tie the corporate structure with subsidiaries and match that to the segments, it would be a lot more helpful for analyzing the segment results. [Also included in 3(b)] **[TC 12/8, p. 19]**

Participant C-5
I guess from the bank credit standpoint, we typically lend at the operating company level. So the legal entity reporting is very important to us because we are lending to different legal entities. Where we did get in holding company credit in the past, we've actually pushed down to operating company levels. Invariably we deal with specialized companies (each company or

borrowing entity is a specialized industry) so there are no segmentations within that. We really do need legal entity reporting. And while segment reporting isn't bad, I don't think it really helps us as much as some of the other items. [Also included in 3(b)] **[TC 12/8, p. 19]**

Participant C-6
We're constantly running into managements that are saying they don't want to disclose segment information for competitive reasons. So we get a lot out of them when they come in and have a one on one discussion with us for an hour. We get more out of that than we'll get out of a financial statement. [Also included in 3(e)] **[TC 12/8, p. 19]**

Participant C-12
I deal mostly with large investment grade institutions, and I find in general they do a pretty good job of giving me information I need to see to know what the core earnings are. For example, [name deleted] in its quarterly press release will give me a chart showing the changes quarter to quarter in ten different items, but they've never told me what they earn in credit card. One of the most basic segments I'd want to get just is not there. So, segment information is my first priority. [Also included in 3(b), 5(a), and 15] **[TC 12/8, p. 28]**

Participant C-16
I'm in the leasing business, and we are continuously asked to extend credit to subsidiaries of major companies, and even subsidiaries of mid-sized companies. The absence of consolidating financial statements is difficult. I guess it's unrealistic to expect consolidating statements on a major company, but certainly for mid-sized companies I'd like to see more segment reporting a greater level of detail. [Also included in 3(b) and 15] **[TC 12/8, p. 28]**

Participant C-9
If I take that further, I think that one reason we may not be getting segment information is I don't think big companies are being operated on that basis. As you say, the banks are operated more on a relationship basis, and there is not always a bottom line accounting of some of those smaller, discrete products. But there are discrete products within the banking industry, the credit cards, the mortgage banking business, and I think there could be more effort on that score. And I think it would be a positive development for both the management of the companies and those of us who evaluate the companies. [Also included in 3(b)] **[TC 12/8, p. 33]**

Participant C-5
There is a lot of compelling that we can do, but at some point you reach a point where you realize they don't have this quality of information. We're the only one asking for it. And it's not even a competition factor at this point, it's the preparation of the material. For example, some of the segment reporting; I mean they're lucky to get a balance sheet and income statement together, let alone segment reporting. It's not necessarily a matter of resisting or fighting or feeling they're so powerful in the relationship that they can tell us what we're

allowed to have. It's really just lack of that understanding of the information. [Also included in 1(b)] **[TC 12/8, p. 58]**

Participant C-9

My comments would harken back to lack of segment reporting. It's very difficult to really forecast much. In fact, being a debt analyst, we're really more concerned about the downside, and so I would have to use some sensitivity analysis to make sure that the fixed charges could be covered, and that there is an ongoing concern. But I'm not as concerned about the upside. [Also included in 1(c)] **[TC 12/8, p. 68]**

To improve financial reporting, from an analyst's point of view, [one analyst] recommended . . . the following. . . : [Also included in 1(b), 2(c), 8(d), 15, and 17(d)] **[BEAR STEARNS, p. 2]**

> Include disaggregated disclosures by operating unit that would show revenues and operating income, cash flows and relative returns for each operating unit. [Also included in 1(b) and 15] **[BEAR STEARNS, p. 2]**

[Context] For companies in the precious metals business, the Mining Industry Subcommittee of the AIMR Corporate Information Committee would like to see improvements in reporting the following:

- Better segmented reporting, particularly in quarterly reports. [Also included in 15] **[AIMR/CIC91, p. 2]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

[One analyst's] main complaint is the lack of segment information. He would like drug companies to report product segments by geographic area. He wants information on new products and their margins. [Also included in 1(b), 13, and 15] **[GOLDMAN, p. 2]**

[Context] November 17, 1992, a committee member and staff met with a buy-side equity analyst. The materials for the first meeting of the Investor Discussion Group provided the basis for the discussion.

> [I]mprovements in disaggregated information should be a high priority. The need [is emphasized] for improved information related to operations in different geographic areas because the risks, prospects for growth and profitability often differ widely depending on the geographic location of the business. [Also included in 15] **[FREEDMAN, p. 3]**

3(b). Basis of Disaggregation

> Most [equity sell-side analysts] reports contain both historical and forecast quarterly and annual income statements or summary information. The most common approach to estimating future EPS is to disaggregate the company into its constituent LOB's and/or geographic regions (both of which are frequently more detailed than GAAP requires), and to then develop forecasts of the performance of individual units which are reaggregated for a company EPS estimate. [Also included in 1(b), 1(c), and 11(e)] **[PREVITS, p. 15]**

[Context] The following brief summary of the topic "Disaggregated Financial Statements," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

> Analysis of a complex economic entity requires information about the workings of each of its components. There is no disagreement among financial analysts that segment information is totally vital to their work. There also is general agreement among analysts that the current segment reporting standard, ***FAS 14***, is inadequate. Recent work by a subcommittee of the FAPC has confirmed that a substantial majority of analysts seek and, when it is available, use quarterly segment data. [Also included in 3(a) and 3(c)] **[AIMR/FAPC92, p. ix]**

> The FASB recently initiated a project on disaggregation for which AIMR is providing partial financial support in addition to its overall endorsement. We do not wish to prejudge the results of research now in its initial stage, but we do suggest an avenue for the FASB's researcher to explore. We believe that segment data are most useful when they depict the way in which the enterprise itself is organized and managed and we urge the FASB to seek ways to promulgate a standard that produces such a result, despite the several difficulties in doing so that we acknowledge and discuss in the report. [Also included in 3(a) and 3(c)] **[AIMR/FAPC92, p. ix]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

> In our previous discussion of quarterly segment reporting we alluded to the needs of analysts for disaggregated financial data. It actually is more than necessary. It is vital, essential, fundamental, indispensable and integral to the investment analysis process. Analysts need to know and understand how the various components of a multifaceted enterprise behave economically. One weak member of the group is analogous to a section of blight on a piece of fruit; it has the potential to spread rot over the entirety. Even in the absence of weakness, different segments will generate dissimilar streams of cash flows to which are attached disparate risks and which bring about unique values. Thus, without disaggregation, there is no sensible way to predict the overall amounts, timing or risks of an complete enterprise's future cash flows. There is little dispute or controversy over the analytic usefulness of disaggregated financial data. [Also included in 3(c)] **[AIMR/FAPC92, p. 39-40]**

There is much controversy over how disaggregated data should be reported. How shall it be classified: by legal entity, by line of business, by geographic area, by type of customer served, by activity (manufacturing, marketing, etc.), by Standard Industrial Code (SIC) number, or any one of many other possibilities? In what degree of detail shall it be presented? How extensive can detailed disclosures be made before financial statement users are so overcome with minutia that they not only cannot comprehend them, but they also lose sight of the overall portrayal of the enterprise? [Also included in 3(c)] **[AIMR/FAPC92, p. 40]**

In an ideal world, an enterprise would report disaggregated data in a format that coincides with and reflects how it is organized and managed. It also would disclose the source and nature of risks that are expected to affect, either positively or negatively, the amounts and timing of its future cash flows. These risks may be associated with geography, product lines, markets, or a variety of other classifications. The enterprise would reveal the boundaries between its assorted legal-entity constituents, thus divulging restrictions on the claims of creditors and movements of cash within the entity. Finally, all of the disaggregated data disclosed would mirror the way the business is organized and managed, while at the same time providing comparability to the disaggregated data of other enterprises. [Also included in 3(c)] **[AIMR/FAPC92, p. 40]**

In the real world, obviously not all of these objectives can be achieved. They require trade-offs and choices. From the standpoint of financial analysis, we believe priority should be given to the production and dissemination of financial data that reflects and reports sensibly the operations of specific enterprises. If we could obtain reports showing the details of how an individual business firm is organized and managed, we would take more responsibility on ourselves to make meaningful comparisons of those data to the unlike data of other firms who conduct their business differently. We realize the extraordinary difficulty of mandating a disclosure standard while maintaining the flexibility of each enterprise to present its own circumstances and organization, but we believe it to be a commendable undertaking. [Also included in 2(c) and 3(c)] **[AIMR/FAPC92, p. 40]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the preliminary discussion on the objectives and approaches of investors and the types of information they use, some investors made comments pertinent to the basis of disaggregated information.

Participant I-12
Segment reporting is something that is absolutely critical to an analyst. For example, for [a large, diverse financial institution], the cash flows generated by the credit card business have entirely different sources and uses than the cash flows generated by the securities business. It's very difficult from what we see to find that out and find a base from which we can forecast. [Also included in 1(a) and 3(a)] **[TI 10/16, p. 4]**

Participant I-5
More segment breakout is a critical thing (consistently presented). Also, as for information that you can get externally that could be provided in the financial statements, if you can get the aggregate statistics for an industry from the government or some statistical service or some trade organization, I think you're better served doing that than relying on the company's annual report, because you are going to some kind of an objective benchmark outside the company. [Also included in 1(b) and 13] **[TI 10/16, p. 20]**

Participant I-12
I head a subcommittee for the AIMR reporting on financial services. What I find interesting going through that exercise every year is that, if you have a diversified financial company like [names deleted], those companies do not report segment data that is comparable to the rest of that particular industry. It has started to get better but the companies are concerned with the cost of preparing that data. But yet, you know they already have the data, they just don't want to publish it. It's really important that when they publish segment data that it bears some resemblance to the industry data in which that segment is competing. [Also included in 3(a)] **[TI 10/16, p. 21]**

Participant I-7
We don't get good FAS 14 disclosure in the annual report and we get less from most of our companies in the quarterly reports. FAS 14 is just an abomination at least in my industry from a quarterly point of view. I also heard the argument about the expense of creating this information. There isn't a reasonable size company that doesn't have internal reporting and the people inside the company get a report card, if not monthly certainly quarterly, and that's the kind of information that is readily available that I would like to see. One of the things that should be discussed somewhere is: what the information that we as outside investors should not be permitted to get from a competitive point of view? They all know internally what their competitors are doing and yet they don't want to provide certain information to us for competitive reasons. It's vital that the accounting profession decide what kinds of information are competitively harmful and others that aren't. [Also included in 1(b), 2(d), 3(a), 3(d), and 11(c)] **[TI 10/16, p. 21]**

Participant I-12
Basically, I've been viewing LDC as a separate segment because sometimes the market ignores the LDC for some period of time and then it may come back to haunt you. [Also included in 1(b)] **[TI 10/16, p. 40]**

Participant I-6
In line with that, I adjust earnings in those situations too because what you really have done now is to set up a new segment of business which is a financial business, not an operating business. So some companies that deals in commodities really have two lines of business; one is making the product, the other one is the financial end of selling it to a financial market and using financial tools to lock in a given revenue stream. Completely two separate businesses

that should be reported under segment accounting, completely outside the traditional revenue recognition cycle. [Also included in 1(b)] **[TI 10/16, p. 43]**

Participant I-1
Coming back to segments. Even within an operating segment, you want to break that molecule down into its atoms. To estimate the ROA for that company, you have to make some guesses on mix; invariably, there are higher margin and lower margin products in there which become a critical "guesstimate" for that model. Anything you can do in that regard would be helpful. **[TI 10/16, p. 56]**

Committee/Staff/Observer
I heard people say that they would like to have more segment information presented the way the company manages its business. But I also heard people say they'd like to have segment information comparable between companies. It seems to me that is contradictory. How do you reconcile that contradiction? [Also included in 2(c)] **[TI 10/16, p. 60]**

Participant I-7
When I talk about comparability, I'm talking about accounting elements, I'm not talking about segment information. At least in my industry, they're not producing a common product; you shouldn't force two companies to look at their segment reporting in the same way. [Also included in 2(c)] **[TI 10/16, p. 60]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information.

Participant I-7
The guidelines have to be tightened up and there has to be additions to the guidelines. For example, where you have a series of businesses where 20% of the sales or earnings of the business comes from a specific unit within the total, that should be shown separately. You can then move on from that point to make FASB 14 more informational than it currently is. [Also included in 3(a)] **[TI 12/9, p. 5]**

Participant I-6
I would go further and lower the 20% to 15% because if a company has 10-15 units, it is hard to get a 20% unit; the 20% would only apply if you have a few dominant units. [Also included in 3(a)] **[TI 12/9, p. 5]**

Participant I-7
The answer is relatively easy. I want a company to report to me the way they report internally. I don't want to spend months or years trying to understand that. [Also included in 3(a)] **[TI 12/9, p. 6]**

Committee/Staff/Observer
The problem with that is that we hear obvious complaints about FASB 14; you want more segment reporting and you also want more uniformity so there can be comparability. There is a dichotomy there: how can different companies report in a way that gives you comparability and at the same time you want the companies the report the way they run their business. Those are two conflicting thoughts. Can we discuss that dichotomy? [Also included in 2(c)] **[TI 12/9, p. 6]**

Participant I-4
It's a conundrum. From our perspective, we would like to have everything we can get. From the perspective of most public companies, I'm not certain they would like to give us all the information for a myriad of reasons, competitive and others. I would tend to think that most companies believe that, while it's important to have Wall Street coverage, more information does not necessarily means higher valuations. **[TI 12/9, p. 6]**

Participant I-11
I think there are some managements that want a lot of Wall Street attention when their business is good and want to hide when it's bad. But to the question at hand, I agree with [participant I-7]. The idea of trying to force every company's financial statements into the same mold fails to recognize that every company is not the same; in fact, no two companies are the same. Our job is to understand the differences between two similar companies so as to be able to decide which is a superior investment and which is the inferior investment. I think we get into more trouble trying to force them all under these rigid molds than we do recognizing those differences. If management is truly the most important thing in evaluating a company, then we want to understand as clearly as we can how management thinks about its businesses. A good place to pursue that is the way management gets information about its businesses. **[TI 12/9, p. 6-7]**

Participant I-7
I accept differences, even in the same business, for the companies that I look at. The quality that I demand is information. I want the information so that I can understand those differences and make as clear an interpretation as I possibly can. On my side, I will tell the company that there is information that we, in the public eye, should not receive; union information, early pricing, product strategies, new products, and the like. But there isn't a medium to large size company that doesn't know what their competitor does within a very reasonable order of magnitude. And any analyst around this table will tell you that you tend over time to find out more about a company from the competition than from the company itself. [Also included in 2(c) and 3(c)] **[TI 12/9, p. 7]**

Committee/Staff/Observer
Those of you who follow public companies, are you also critical of the combination of FASB 14 plus the line of business disclosure required by the SEC? Do the two disclosures taken together get you closer to what you want? **[TI 12/9, p. 7]**

Participant I-7
FASB 14 is a good start; it just doesn't go far enough. Particularly for the large companies that I follow or the small and medium-sized companies that are reasonably diverse. **[TI 12/9, p. 7]**

Committee/Staff/Observer
Would I be correct in concluding that on the direct question as to whether you want more information based upon the way the company is managed or make all companies fit in into some kind of formula for comparability, you clearly choose how the company is managed. Anybody disagrees with that? **[TI 12/9, p. 7]**

Participant I-9
I don't disagree but I think we're trying to give a one-dimensional answer to something that is a fairly broad range. If you're looking at [one company] or [another company] where they move a drug from being prescribed by a doctor to the consumer sector where you can order it, what we want is really comparability, to have the statements recast. Or if they lump a major profit center like Japan with a loss operation in Korea or Thailand, we don't want them to understate the results of Japan and average it out. On the other hand, I remember looking at [a third company] years ago when I was an insider. We got consolidating statements; they had a sugar company, a movie company, a financial services company, a shoe company. They could report any number that they wanted on a segment basis for a period of a year or two and there was no way that anybody on the outside could lay a glove on that disclosure. But the information that was published was misleading; it was worse than if you didn't have it and I'm sure the company did it that way deliberately. On the other hand, if [a fourth company] has a huge wholesale business with low margins and big sales, I would hope that it would be segmented out as a different category to give a clearer picture. **[TI 12/9, p. 8]**

Participant I-8
If you're looking for some models, there is a company that is a world leader in its business and year-in year-out gets the award in its category for the best annual report; it's a Long Island company called [name deleted]. They abide by the spirit of FASB 14; they break the information down into three major market segments and, within the text of the report, each of those segments is further broken down in the way they are organized. I would recommend that annual report to you as a model; clearly the best annual report I have ever seen by any company. **[TI 12/9, p. 8]**

Participant I-11
I second [participant I-8] on that one. **[TI 12/9, p. 8]**

Participant I-8
They also mention their major competitors, what they do well, what they do poorly, what the company does well, etc. It's everything you would want. **[TI 12/9, p. 9]**

Participant I-6
As a bare minimum, when management is talking about its businesses in the shareholders' letter, you should be able to reconcile those comments to the financial statements. To talk about your business as you see it in the letter and then not have any detail behind it in the

financial statements is absolutely wrong. Second, I wish the FASB would take away the option of reporting segment information quarterly; if it's worth doing annually, it's worth doing quarterly. **[TI 12/9, p. 9]**

Participant I-7
Information about area or market line are also important. About 3 or 4 years ago, there was a big flap over a company called [name deleted]. There was a major surprise that so much of the offshore profits came from Brasil. Of course, Brasil was having one of its usual currency problems. Most of the companies will break out North America, Europe, and ROW or other. With the currency problems today, I submit that it's not enough. **[TI 12/9, p. 9]**

Participant I-6
Another company that fits that same example is [name deleted]. It was a big surprise to the investment community in 1989-90 when earnings went down that something like 80% of their prior year earnings had come from alumina sales out of Australia. You need to break it out by country and by more segments. [Name deleted] is not just an aluminum company; very little of their profits actually come from making aluminum products. **[TI 12/9, p. 9]**

Committee/Staff/Observer
I would like to ask whether you agree with the following statement: "The purpose of segment reporting is to present disaggregated information about those portions of the business having significantly different opportunities and risks relative to other portions of the business, while grouping information about portions of the business with similar opportunities and risks." If you don't agree with the statement, please help us understand what we have missed. **[TI 12/9, p. 9-10]**

Participant I-6
It depends how you define opportunities and risks. I would hate to see gold and copper operations that have similar sales opportunities and risks lumped into one mining segment, instead of breaking down the information by different commodities and operations. Copper is a lot different than gold; what could happen is that gold would go to $800 an ounce, copper to 20 cents and on average, the company is doing OK. **[TI 12/9, p. 10]**

Participant I-11
Well, there are clearly different risks and opportunities there, aren't there? **[TI 12/9, p. 10]**

Committee/Staff/Observer
So that would meet the definition of different opportunities and risks? **[TI 12/9, p. 10]**

Participant I-6
I think management would define them as the same opportunities and risks. They are all mining and the risk is the commodity price. **[TI 12/9, p. 10]**

Committee/Staff/Observer
I would like to ask whether you would define those commodities as having the same opportunities and risks? **[TI 12/9, p. 10]**

Participant I-6
No. **[TI 12/9, p. 10]**

Committee/Staff/Observer
Is it fair to say that you would agree with the concept of our definition but your point is not to let a rule this vague because management will interpret that rule as they deem fit? **[TI 12/9, p. 10]**

Participant I-6
Exactly. **[TI 12/9, p. 11]**

Participant I-7
There are generic terms in any industry, especially electrical equipment. For motors, you can go from fractional on the AC side to 50,000 horse power for drag lines on the DC side and you get a category called motors. You can do the same thing for transformers; the kind outside your house as opposed to the kind that is outside the power station and the demands are totally different and the served markets are also different. **[TI 12/9, p. 11]**

Participant I-12
The notion of opportunities and risks makes a lot of sense, but I would also focus on the different characteristics that affect profits. For example, processing transactions has an entirely different nature than lending money. Ultimately, I guess it comes back to opportunities and risks but I want to get that notion of fundamental characteristics out on the table. **[TI 12/9, p. 11]**

Participant I-5
Opportunities and risks is such a broad definition. What are you really saying by getting that far? **[TI 12/9, p. 11]**

Committee/Staff/Observer
On page 7 [of the meeting materials], we talk about bases of disaggregation other than by industry segment. We understand that disaggregated information by industry segment is critical to your analysis but we are also aware that, in certain cases, in addition to industry segments, investors may require disaggregated information based on other bases. These bases may be important drivers of the opportunities and risks faced by the business. On page 7, under question 4, we list several bases for disaggregation. For each case, we would like to know under what circumstances is the information critical and, if it is, how often do you encounter these circumstances? **[TI 12/9, p. 11]**

Let's take them on one at a time. Geographic information by location of operations? **[TI 12/9, p. 12]**

Participant I-13
Yes. For example, a gold mining company with operations worldwide; in North America, where political risk is nonexistent or very low, versus operations in Papua New Guinea or South Africa, where political risk might be higher. That's important for investors to know. **[TI 12/9, p. 12]**

Participant I-12
I agree. It makes a big difference whether you're making a loan to Brasil or a loan in New England, although some would say that's the same. In the securities business, there is also a big difference on the spreads you get in Hong Kong from those in the New York Stock Exchange. So you do have very important differences by geographic location. **[TI 12/9, p. 12]**

Committee/Staff/Observer
How about locations by markets? Not where the physical plants of the company are located, but the location of its markets? **[TI 12/9, p. 12]**

Participant I-8
I think that's important too. Some companies give you US or North America, Europe, and the rest of the world, some will give you Asia Pacific, and others will go further and break that down into Japan and the rest of Asia Pacific. The more you get, the better it is. **[TI 12/9, p. 12]**

Participant I-7
To come back to foreign currencies, you better know where your major markets are. You better know what your transaction prices are. **[TI 12/9, p. 12]**

Participant I-5
The distinction between location of operations and location of markets depends on what piece of financial information you are looking for. If you're looking at revenues by area, you're talking about markets; if you're talking about assets by area, you're talking about locations. **[TI 12/9, p. 12-13]**

Participant I-6
I think information by markets is important. For example, a company as [name deleted], which is basically a metal and mining company, also has a big specialty chemical operation; they do give a segment breakdown on specialty chemicals but that's all you get. If you visit the specialty chemical group, they talk about their European operation which is major, their Asia Pacific operation which is major, and some in Mexico and Canada. They will give you Asia Pacific sales which include all the copper, zinc, specialty chemicals and everything; this is a meaningless number. **[TI 12/9, p. 13]**

Participant I-9
The geographic breakdown by markets is absolutely crucial for the health care industry because the pricing in the different markets is different. It's probably the most important information for a pharmaceutical company. In this case, you don't care where the product is produced, but you care where it's sold. **[TI 12/9, p. 13]**

Committee/Staff/Observer
How about regulated versus non-regulated? **[TI 12/9, p. 13]**

Participant I-11
Are there any non-regulated businesses? **[TI 12/9, p. 13]**

Participant I-7
That brings up an interesting point. Most people understand which industries are alleged to be regulated and which are not. However, most or a number of industries that are clearly not considered regulated have very stringent legal regulations. The best example of that is the media business which is very competitive; 12-15 years ago, the fencing rule promulgated by the FCC did not allow the major networks to get after syndication dollars which is a $5.5 billion a year pot. There is a lot of action going on in the courts now to overturn that regulation. **[TI 12/9, p. 13]**

Participant I-12
Most of the companies I cover are highly regulated and some are just ridiculously regulated. The interesting thing about this is that you have a single business which will have competitors, some of whom are regulated and others of whom are not regulated and abide by different rules. My favorite example goes back to bank and bad loans. When a bank has a bad loan, 100% of the loan has to be noted as not paying interest. Whereas [name deleted] had a loan for $60 million of which $15 million was classified as non-performing; under their reporting rules, that $15 million is their estimate of their potential ultimate loss. Whenever I see anything from them related to loans, I just multiply by 4! I don't know if it's an accounting profession problem but this is an issue, and I doubt that the financial services industry is the only industry with that kind of problem (differential accounting for the same kind of situation). It's very important in terms of line of business reporting. [Also included in 2(c)] **[TI 12/9, p. 14]**

Participant I-7
That's why I argue for the allowance of differences so long as there is disclosure. [Also included in 2(c)] **[TI 12/9, p. 14]**

Participant I-5
The distinction between regulated and non-regulated intertwines between borrowing unit and legal entity. If you take regulated to mean a business that is regulated at a financial level (like a casino precluded from upstreaming dividends, or insurance companies), they are different borrowing units and different legal entities. **[TI 12/9, p. 14]**

Committee/Staff/Observer
I don't think that that was what we meant by regulated versus non-regulated. It's more like a utility business where rates are fixed by public service commissions. **[TI 12/9, p. 14]**

Participant I-6
Could we include in that definition environmental regulations? And if so, then we got smelters that are built in Chile versus Nevada. **[TI 12/9, p. 14]**

Participant I-11
My earlier remark was not entirely facetious. The reality is every company faces some level of regulation and it's a continuum. You have to be real careful; you may be opening a can of

worms if you're trying to require some disclosure based on regulated versus non-regulated. We as analysts probably have to be more scrupulous than I suspect most of us have been in being aware of these regulations that affect the companies we follow. **[TI 12/9, p. 15]**

Committee/Staff/Observer
I think what we had in our minds when we raised this issue is a company that would be perceived by the public to be regulated, like a bank or a public utility company or an insurance company, but that may have a significant portion of its operations that are not regulated, and whether it would be important in that circumstance to segregate those operations and provide the kinds of disclosure we have been talking about. **[TI 12/9, p. 15]**

Participant I-12
In most of those regulated businesses, I can go to the FDIC and get a Call Report on a bank any day of the week. I'm not sure that it is an appropriate basis for determining line of business reporting. If you ask [two companies] to report their regulated banking activities versus anything else, you would get the same information you are getting today, which is sort of no-segment kind of information. I have trouble with that. **[TI 12/9, p. 15-16]**

Participant I-7
The answer to your question is absolutely yes. What you are seeing increasingly is regulated industries moving outside of their basic business. **[TI 12/9, p. 16]**

Participant I-9
I used to cover the telephone industry and I think it's very important to have their non-regulated revenues shown. I don't think the profits are important because there is too much shared cost; the profit figures can be manipulated. [Name deleted] is a case in point. **[TI 12/9, p. 16]**

Committee/Staff/Observer
How about the legal entity basis for disaggregated information? **[TI 12/9, p. 16]**

Participant I-8
If you mean all the separate corporations, I think that would be too cumbersome. **[TI 12/9, p. 16]**

Participant I-6
I'm in his camp. I'd love to see it because it would force the companies to clean up a lot of stuff and do away with paperwork. Look at [name deleted] with 1,000 separate legal coal companies. **[TI 12/9, p. 16]**

Participant I-7
Where this really pays to know was in the [name deleted] era where, if you were in a certain state, it was either easier or more difficult for takeovers. **[TI 12/9, p. 16]**

Participant I-4
I think you're talking about legal entities that are constructed for tax reasons in a lot of cases. **[TI 12/9, p. 16]**

Participant I-12
There are legal entities that are constructed for regulatory reasons. I once looked at the 200-page [company] document that listed all the legal entities that constituted [that company]; it's a daunting prospect. **[TI 12/9, p. 17]**

Participant I-4
Who could possibly be interested in that? **[TI 12/9, p. 17]**

Committee/Staff/Observer
The banks that loan these companies money usually loan to legal entities as opposed to economic entities. **[TI 12/9, p. 17]**

Participant I-5
So you're getting to borrowing-unit-legal-entity. **[TI 12/9, p. 17]**

Committee/Staff/Observer
If you take the legal entity concept and take two cuts at it, parent company versus all of its subsidiaries, would you change your answer? **[TI 12/9, p. 17]**

Participant I-6
I would as long as the subsidiaries are classified into industry segments. Even without that, I probably would. But I wouldn't want to see all the legal entities, it's too cumbersome. **[TI 12/9, p. 17]**

Committee/Staff/Observer
The parent company could be a holding company and, in order to pay dividends, might have to get dividends up. European companies conventionally disclose parent companies; we do not do that in this country. **[TI 12/9, p. 17]**

Participant I-12
We do that because there is a requirement. There are not many companies that are true holding companies where you have a non-operating holding company that holds subsidiaries. Banking is most often where you find it and maybe some public service companies. They are required to report parent-only statements separately under SEC guidelines. **[TI 12/9, p. 17-18]**

Participant I-11
There are a number of reasons for which companies establish legal entities. Many of those are not economic reasons; they are regulatory, liability, tax. I'm not sure those legal entities are terribly relevant to us. We're more interested in the economic units. I can think of two companies, one which has its operations organized into subsidiaries, the other into divisions; totally different legal structures for the same economic structure. **[TI 12/9, p. 18]**

Committee/Staff/Observer
How about individual product or product group, even within an industry? **[TI 12/9, p. 18]**

Participant I-13
Yes. **[TI 12/9, p. 18]**

Participant I-8
That would cover cases where a company says it's in the electronics business but it really is in 3 different businesses within that. **[TI 12/9, p. 18]**

Participant I-13
I cover a minuscule industry called the precious metals mining business. I have been on a crusade for some time to get gold mining companies to adopt a standardized quarterly reporting format. That would save a great amount of time to analysts because they would know where to look to find the pieces of information they're interested in. It would be easy to impose a standardized format for an industry like mine because the companies are likely to be more uniform in the nature of the business that they're in. In that standardized format, the companies would give us cost by $ millions and revenue per product. In that way, you can build a quarterly income statement based on production data. [Also included in 3(e) and 11(c)] **[TI 12/9, p. 18]**

Participant I-12
I have a different problem with the companies that I cover; how do you define the product, product group, or even industry? For example, under an SIC code basis, I believe that credit card businesses carried on by banks are still classified as banking. We're in a world that's evolving where product and industry definitions are changing; it seems to me that the focus should be on the economic units and the fundamental operating characteristics and how they relate to revenues and expenses. **[TI 12/9, p. 19]**

Committee/Staff/Observer
I skipped borrowing unit after legal entity. Any comments on how important is disaggregation information by borrowing unit? **[TI 12/9, p. 19]**

Participant I-6
I would have a little interest in it. The mining industry is global; when I look at a mining company, I would like to know whether project financing is taken out against one of the big profitable mines and not against the other less profitable mines. But it's not that big of a deal to me. **[TI 12/9, p. 19]**

Participant I-5
I follow distressed bonds; so for me it's absolutely critical. **[TI 12/9, p. 19]**

Committee/Staff/Observer
How about purchases from major vendors? **[TI 12/9, p. 19]**

Participant I-8
The only place where I think it could be crucial is if there were some exotic mineral that could only come from one place in the world. But other than that, I don't see the necessity for that information. **[TI 12/9, p. 19]**

Participant I-7
I think this is extreme; most companies have multiple vendors. I'm sure somebody could come up with one particular example; when it's so significant, one would like to see the disclosure. **[TI 12/9, p. 19]**

Participant I-8
You tend not to worry about vendors unless it's crucial. **[TI 12/9, p. 20]**

Participant I-6
I don't care if the information is there or not. I'd like to know but for a devious reason; Alcoa is the largest supplier of alumina in the world, so I know that [Company A] (3rd largest aluminum company in North America) buys 100% of its alumina from [Company B]. Since [Company B] doesn't give me any information, I would learn a lot from [Company A] disclosure. It would tell you a lot about the producing company that is burying the information. **[TI 12/9, p. 20]**

Participant I-11
I think the risk element is the key thing. The other side of the risk element is if you have major customers that could cause problems. **[TI 12/9, p. 20]**

Committee/Staff/Observer
The trouble is how do you define a threshold? **[TI 12/9, p. 20]**

Participant I-6
I would do it more along the materiality concept. If it's material, let's disclose it; then, we can debate materiality. **[TI 12/9, p. 20]**

Participant I-7
I would like to see sales to major customers. **[TI 12/9, p. 20]**

Participant I-8
There is already a requirement for that in FASB 14; I think when the sales represent 10% of sales. **[TI 12/9, p. 20]**

Committee/Staff/Observer
Other candidates for basis of disaggregation? **[TI 12/9, p. 20]**

Participant I-12
I mentioned operating characteristics but I'm not sure how you would make that a specific basis; that's kind of vague. **[TI 12/9, p. 21]**

Participant I-9
The accountants should put on the hat of somebody using those statements from the outside, and see if there is something that somebody trying to make security valuations would find misleading. You should not have any segments that blend a cash and carry business with a present value annuity stream because it's absolutely worthless. **[TI 12/9, p. 21]**

Participant I-6
This goes back to [participant I-7]'s earlier point; give us the information as you manage the company. If you do that, you have the data available every quarter. [Also included in 3(d)] **[TI 12/9, p. 27]**

Participant I-11
I don't agree with [participant I-9] on that. I am an advocate of having management report to me the way they manage their business. They have that information; the cost argument doesn't hold. And if they don't have it, then they're lousy managers and maybe I'm helping them out by forcing them to get the information together. [Also included in 3(d)] **[TI 12/9, p. 27]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of disaggregated information.

Participant C-3
I think the way financial institutions have looked at the current segment reporting rules is that if I service a certain customer and provide different types of services to that customer, it's one segment, because it's one customer. And I wonder whether the rules ought to be geared to the types of services that are being provided and the types of revenues that are being generated. [Also included in 3(a)] **[TC 12/8, p. 18]**

Participant C-12
I don't have a good answer, but the information could be broken down by management reporting categories. That's ironic that when we look at a finance company report or a bank report, they're in one line of business; but if you talk to them, you talk to a half a dozen people, and they tell you about the different discrete businesses they are in. They're already preparing that information. [Also included in 3(a)] **[TC 12/8, p. 18-19]**

Participant C-4
One problem with segment reporting is that a lot of the companies that are required to report on a segment basis don't report internally on that basis. If we could somehow tie the corporate structure with subsidiaries and match that to the segments, it would be a lot more helpful for analyzing the segment results. [Also included in 3(a)] **[TC 12/8, p. 19]**

Participant C-9
I want to see if I understood you. You're saying that if you have a particular segment, you'd like to know what percentage is related to various legal entities? **[TC 12/8, p. 19]**

Participant C-4
Various subsidiaries, yes. **[TC 12/8, p. 19]**

Participant C-5
I guess from the bank credit standpoint, we typically lend at the operating company level. So the legal entity reporting is very important to us because we are lending to different legal entities. Where we did get in holding company credit in the past, we've actually pushed down to operating company levels. Invariably we deal with specialized companies (each company or borrowing entity is a specialized industry) so there are no segmentations within that. We really do need legal entity reporting. And while segment reporting isn't bad, I don't think it really helps us as much as some of the other items. [Also included in 3(a)] **[TC 12/8, p. 19]**

Participant C-11
I think there is a conflict to think about between a legal entity and business segment as you look at how different people analyze things, and not just debt versus equity analysts, but people with different interests, maybe. I think there are times when a legal entity does embrace a business segment, and it's certainly the most logical thing to deal with. But there are other times when not all of an operating business segment is included in a legal entity framework; there's part of it there and part of it somewhere else. I think that you have to understand the segment operations broadly, and how they all fit together. You can get too technical just by looking at a legal entity if it does not embrace the whole business that you have to ultimately rely on to get paid off. **[TC 12/8, p. 20]**

Participant C-1
But that' the problem; legal entities determine how you get paid off. The classic example with that would be [two companies] where trade creditors who shipped directly to legal entities, such as [name deleted], got paid off 100 cents on the dollar. Trade creditors who shipped to the holding company got paid off with the rest of the unsecured creditors and it was about 30 cents on the dollar. I think you're right, we can get too technical, but in some instances this concept of legal entity, of at least where debt or trade claims are, can be very important. **[TC 12/8, p. 20]**

Participant C-11
Well, your comment is right so I guess that I would have to say that you have to know both aspects. **[TC 12/8, p. 20]**

Participant C-12
As soon as we make something primary, management manages to that, and lets other things slide. But it's not a great hardship to do multiple cuts of a company. If I look at [name deleted], I'd like to know what the individual banks look like. I'd also like to know what credit card looks like. And I know they house that in different pieces of the institutions. **[TC 12/8, p. 20]**

Committee/Staff/Observer

It's a general question on the subject of disaggregated information. Is it feasible, having heard what I just heard about the needs and wants and desires, for a set of external reported financial statements to meet all of these needs? **[TC 12/8, p. 22]**

Participant C-14
We find that a lot of our needs are met when we asked for the consolidating financial statements. What we look at is what legal entity is the debt at, and ultimately that's what's going to prevail. If we have the consolidating financial statements, we can do what we think is the most important part of the due diligence in evaluating what the cash flow is of the legal entity relative to the debt at that entity. **[TC 12/8, p. 22]**

Committee/Staff/Observer
So you would seek those consolidating statements from management? **[TC 12/8, p. 22]**

Participant C-14
We ask for them in every situation where there is more than one legal entity. And usually we've had to spend a lot more time on those statements than on the statements that are published by the company. **[TC 12/8, p. 22]**

Participant C-11
I think my concern is that you're going to end up getting a primary report. You can't get both legal and business segments. Or at least that's my concern. So that given a choice, to the extent that an operating business is done in two or three or four different places, I am unhappy if I cannot get the thing put together in one business segment statement. **[TC 12/8, p. 22]**

Participant C-5
We've done some significant analysis in terms of moving to a re-rating system within our bank, modifying the past rating approach. What we've seen is a point where you shift your focus, whether it's accrual versus cash. On the high end credit accrual is very important because it really does get down to period reporting. Cash becomes important when liquidity and viability is more of a question. The same thing goes with things like segment reporting versus legal entity. The more concerned I am about viability, the further I move down the curve. If I am more concerned with the pieces of the debt, how I control the debt structure with the whole consolidated group, I then move up the curve. Businesses are not managing legal entities, they really are managing segments. The concept should be that we have a set of tools; obviously, as a bank creditor we can demand preparation of financial statements in certain fashions as long as we have an agreed-upon standard upon which those can be prepared. For a company that we would grade a borderline pass credit, we would not ask for segment reporting, we'd need legal entity consolidations. For a company that's a high grade multinational, typically they would provide more segment-type information. I don't believe standards should be different but the on-off switch should be there to shift the focus in the middle at the point where the debt holders make some determinations as to which are more important. I know that's a difficult thing to implement, but we have clearly seen that there is a shift about middle of the pass grade, which would be basically minimum investment grade type credit, there's a shift away from cash viability to accrual and legal entity to segment type information. [Also included in 1(a)] **[TC 12/8, p. 22-23]**

Participant C-12
I deal mostly with large investment grade institutions, and I find in general they do a pretty good job of giving me information I need to see to know what the core earnings are. For example, [name deleted] in its quarterly press release will give me a chart showing the changes quarter to quarter in ten different items, but they've never told me what they earn in credit card. One of the most basic segments I'd want to get just is not there. So, segment information is my first priority. [Also included in 3(a), 5(a), and 15] **[TC 12/8, p. 28]**

Participant C-16
I'm in the leasing business, and we are continuously asked to extend credit to subsidiaries of major companies, and even subsidiaries of mid-sized companies. The absence of consolidating financial statements is difficult. I guess it's unrealistic to expect consolidating statements on a major company, but certainly for mid-sized companies I'd like to see more segment reporting a greater level of detail. [Also included in 3(a) and 15] **[TC 12/8, p. 28]**

Committee/Staff/Observer
Is there anything more that needs to be said about disaggregated approaches (what additional bases of disaggregated information would you like to see reported) other than the notion of legal entity, and whether or not you combine legal entities together to get segments? **[TC 12/8, p. 30]**

Participant C-10
The fourth and the fifth points about individual product or product group and purchases by major vendor are both important bases. In other words, I want information about any segment that the management can control, any little variable in the company and the way they work their company, so that we can understand if there is a gross margin of 27% here and 23% here, and that this part of the business is 20% growing to 50%, and that type of thing. We're trying to understand where the management has the ability to deliver an improvement in their company's operations. **[TC 12/8, p. 30]**

Participant C-5
I had comparable operations as category. To understand core earnings and what the improvement of the trend line is in core earnings, you need to understand disaggregated businesses and the impact of discontinued operations. **[TC 12/8, p. 31]**

Participant C-12
I had management units. This is anything over 10% in revenues or income. And I know what I mean by management unit, because management tells me how they divvy the business up. I'm not sure how one can impose that externally. Also, at some point you could say that if a company is of a given size, they've got to have a minimum number of segments; that if you are [name deleted] and you have one business, you've got the one bank, but you're all over the state of California, you're really in multiple segments, you're in consumer banking, real estate banking, and break it up. At some point you get big enough, you have to be able to cut it in multiple ways. And that's not true of a $20 million bank, but by the time you get to $50 billion it is true. **[TC 12/8, p. 31]**

Participant C-13
Just to pick up on that, 10% of income is far too broad a definition. Companies growing at 5% a year, that's two years' growth. The materiality standards should be related to changes in income and cash flows. **[TC 12/8, p. 31]**

Committee/Staff/Observer
I'm a little confused, and perhaps some of the commentators on the need for segment information can clarify this for me. The fourth bullet talks about product line, and I'm wondering if some of these comments are driving toward more disclosure of product lines within segments? **[TC 12/8, p. 31]**

Participant C-10
Yes. You want to understand what that significant piece of the business is going to do, and that's one product line. **[TC 12/8, p. 31]**

Participant C-3
Increasingly, we're getting into an argument of what's proprietary and what isn't, though, and where do you draw the line between what types of information should users of financial statements have, and what we shouldn't have. So maybe the best way to approach the issue of how do you define a segment is based on revenue volatility, and not individual products or individual legal entities, although I guess the legal entity issue is important. [Also included in 2(d)] **[TC 12/8, p. 32]**

Participant C-13
I think it's more a matter of the way the company runs the business. Just take another real life example, there is a financial company that's currently in registration, and basic business which is 80% of their business has about an 8% operating profit margin. The rest of their business is currently close to break even, losing money; that part of the business is being downsized. They're entering into a new business which has about a 5% profit margin which they expect to grow at a very rapid rate. And yet that information comes from conversation with the company, and that's nowhere disclosed in the financial statements, although the company happens to be in registration as well. **[TC 12/8, p. 32]**

Participant C-5
In the financial institutions where consumer products are in fact products and they're managed that way, I would still be careful about the use of product terminology in financial institutions, because letters of credit or interest rate swaps are quite often just an extension of a relationship activity. For example, at one point we had fixed rate loans, so therefore we had one product bundled together. We've disaggregated the product, but we really manage it as a relationship business. I think the point that was made is how you manage the business, how you think of it, and then report accordingly. Banks would report on a customer grouping basis, not by industry. It's more commercial customer, real estate customer, consumer customer. It seems overly simplistic, but banks are a maze of both products and relationships. **[TC 12/8, p. 32]**

Participant C-9
If I take that further, I think that one reason we may not be getting segment information is I don't think big companies are being operated on that basis. As you say, the banks are operated more on a relationship basis, and there is not always a bottom line accounting of some of those smaller, discrete products. But there are discrete products within the banking industry, the credit cards, the mortgage banking business, and I think there could be more effort on that score. And I think it would be a positive development for both the management of the companies and those of us who evaluate the companies. [Also included in 3(a)] **[TC 12/8, p. 33]**

Participant C-4
Speaking about segment reporting, the management of segments is probably done on maybe some other basis, legal entity, or some other method of reporting. I think when we're trying to determine what's going to happen with the segment, the legal entity is very important, because that's typically how management is going to dispose of that segment. I don't think management typically sells a segment, they sell subsidiaries within that segment. And I'm just trying to drive home the point of reporting segment information on a legal entity basis, as well as another segment basis. **[TC 12/8, p. 33]**

Participant C-12
I would much rather have them do more on an annual basis. Because if I look at [name deleted] today, I'd like them to do a product cut for me, a geographic cut, a legal entity cut. And I don't know that I want all that quarterly, but each of those has some meaning, at least. [Also included in 3(d) and 11(c)] **[TC 12/8, p. 38-39]**

[Context] Responses to the postmeeting questionnaire of the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 5

a. Various alternative means of disaggregating financial information were proposed by meeting participants. Please indicate below your preference for the kind of disaggregation that should be provided. That is, mark "1" next to the disaggregation basis you most prefer in credit analysis, mark "8" next to the disaggregation method you least prefer:

Disaggregation by:

	Priority	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
i. Legal Entity	_____	9	3		1	1		1	
ii. FAS 14 industry segment, as defined	_____	1	2	3	2	2	1	1	1
iii. Borrowing unit	_____	5	6		1	1		2	

iv. Management responsibility assignment _____ 2 3 2 1 2 2 2

v. Geography - by location of operators _____ 1 4 3 2 4 1

vi. Geography - by location of markets _____ 1 1 2 2 4 4 1

vii. Individual product or product group within an industry _____ 3 5 2 1 3 1

viii. Other:____________________

Participant C-3 - Under item iv: See b ii.

Participant C-15 - Under Other: Profit contribution by segment.

Participant C-11 - I prefer segment data that best reflects that operations and risks of the enterprise. These can vary from company to company. I do not necessarily prefer legal entity or borrowing per se, since in some cases these do not embrace all operating risks of a business segment. For example, some retailers would include only some customer receivables in their narrow-focus credit sales.

Participant C-9 - 1 and 2 are by far the overwhelming priorities - indifferent after 4.

b. Many at the meeting expressed a preference for disaggregated disclosures that are consistent with the way management responsibility is delegated within the reporting organization. At the same meeting, suggestions were made for reporting improvements that enhance the comparability of financial reports by industries/disaggregated units within the same industry. It can be argued that allowing/encouraging disaggregated disclosures along the unique lines of authority within an organization frustrates intercompany comparability. That is, similar companies with similar industrial activities might provide significantly different disaggregated information to the extent their internal organizations differ.

Help us better understand your needs by answering the following regarding the relative importance of disaggregated disclosures versus comparability:

i. Do you agree that allowing companies to use subjective criteria for how information is disaggregated could result in less comparable information?

YES	NO
16	1

If NO, please explain your response:

Participant C-3 - Absolutely!

Participant C-15 - Maybe there should be more than one basis of presentation.

Participant C-7 - As a bank, our primary focus is the operations of our borrower. The ability to obtain disclosure is a matter for negotiation, not mandate.

Participant C-12 - 1) Less comparable with what? 2) Most companies manage to units that are fairly obvious, *i.e.*, there aren't many ways to divide a business, and managers at different companies tend to agree on the appropriate divisions (and competitive pressure force companies to align their businesses similarly to competitors). 3) Company management will respond to greater disaggregation by lining up their businesses along common lines: competitions will demand this and investors will demand this.

Participant C-11 - Except for small, single-product companies, there isn't that much comparability in a narrow sense. I vote for relevance and reliability over comparability.

ii. Do you have suggestions for mitigating the effects of disaggregation by management responsibility on comparability?

Participant C-3 - I would never promulgate a standard that uses management responsibility as a basis for disaggregation, because it allows the reporting entity too much leeway in reporting results. You'll get <u>less</u> detail (for example, management could easily realign the organizational structure to support less detailed disclosure).

Participant C-14 - The key is to be able to analyze the cash flow generating capability and resources of the <u>borrowing</u> entity.

Participant C-15 - See i.

Participant C-12 - 1) A lot of companies aren't comparable to anything now, so breaking them into pieces, some of which are more easily compared, will be an improvement on the current situation. 2) Breaking businesses into "unitary" components makes them useful without direct comparisons: (a) level and trend of profits by unit, (b) concentration/diversification of profits.

Participant C-5 - Minimum standards by legal structure, product and geography could sustain comparability.

Participant C-4 - Allow for disaggregation by management responsibility, but require management to disclose why their disaggregation method is preferred and to disclose what industries are <u>proportionately</u> included in their disaggregated segments.

Participant C-11 - No. Ultimately, pressures from analysts and preparers and the good will of company managements are the essential elements for good segment disclosure.

Participant C-13 - I believe that the management responsibility criteria is not the most helpful, but it has the advantage that managements cannot claim that the costs of preparing the information exceed the benefits, since they must prepare the information for due diligence on

part of Board, etc. Maybe better definitions and more oversight by SEC of compliance with FAS 14.

iii. If you believe there is an inherent conflict between 1) the management responsibility approach to disaggregation and 2) comparability, which should be given greater importance in financial reporting:

10 _ Comparability

6 _ Disaggregation

Comments:

Participant C-14 - As industry analysts, we tend to know how a company should be performing within the peer group. What we need is to have the disaggregated information to make a more meaningful analysis of the borrowers inherent ability to repay.

Participant C-10 - Our goal is comparing disaggregated data for that one company - not against industry data.

Participant C-7 - In commercial lending, each transaction is somewhat unique, disaggregation would provide greater insight into the operations of our borrowers.

Participant C-12 - I can always make adjustments for greater comparability, but I can't disaggregate by myself.

Participant C-5 - 1) Legal disaggregation, 2) Comparability and 3) Disaggregation.

Participant C-4 - Comparability to industry results and to historic results of the segment are vital. Objectivity and consistency are essential for this comparison.

Participant C-18 - Comparability - STRONGLY!

Participant C-9 - Those interested in further information by management responsibility may well be in a position to request it.

Participant C-2 - Comparability is critical to the comparisons of a borrower's financial information to others within the same industry, which is an integral part of the credit analysis.

Participant C-13 - Tough call!
[Also included in 2(c)] **[PMQC 12/8, p. 12-16]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 1

At the December 9, 1992 meeting, we discussed several bases for disaggregating financial information. Please indicate below your preference for the basis or bases of disaggregated information you would like to obtain. That is, mark "1" next to the disaggregation basis you most prefer, mark "8" next to the disaggregation basis you least prefer.

Disaggregation by:

Rank each item
1 through 8 (use a
number only once)

i. Legal entity	
Ranking	Number of responses
7	*6*
Average Ranking	*7*

ii. Industry segment, based on type of product or service provided	
Ranking	Number of responses
1	*1*
2	*3*
3	*2*
Average Ranking	*2.17*

iii. Borrowing unit	
Ranking	Number of responses
6	*5*
8	*1*
Average Ranking	*6.33*

iv. Segmentation based on internal reporting to senior management or the Board of Directors	
Ranking	Number of responses
1	*4*
4	*1*
5	*1*
Average Ranking	*2.17*

v. Geography--by location of operations	
Ranking	Number of responses

3(b). **Basis of Disaggregation--Page 25**

4	*1*
5	*4*
6	*1*
Average Ranking	*5*

vi. Geography--by location of markets	
Ranking	Number of responses
4	*3*
3	*3*
Average Ranking	*3.5*

vii. Individual product or product group within	
Ranking	Number of responses
1	*1*
2	*3*
4	*1*
3	*1*
Average Ranking	*2.33*

Summary of Rankings		Average Ranking
iv.	Segmentation based on internal reporting to senior management or the Board of Directors	2.17
ii.	Industry segment, based on type of product or service provided	2.17
vii.	Individual product or product group within	2.33
vi.	Geography--by location of markets	3.50
v.	Geography--by location of operations	5.00
iii.	Borrowing unit	6.33
i.	Legal entity	7.00

[PMQI 12/9 and 1/13, p. 1-2]

QUESTION 2

a. Many participants at the December 9, 1992 meeting expressed a preference for disaggregated disclosures that are consistent with the way the company views itself and reports internally. At the same time, participants have emphasized the need for comparability of financial reports among companies, particularly within the same industry. Unfortunately, segmentation based on internal reporting may be inconsistent with better comparability. That is, similar companies with similar operations might provide significantly different disaggregated information solely because their internal organizations differ.

However, our understanding is that investors would prefer segment reporting consistent with the way the company views itself internally, rather than based on other approaches that would result in more comparable disaggregated information among companies. In other words, in the area of segment reporting, investors assign greater importance to the relevance of information based on internal reporting than to comparability among companies. Is our understanding correct?

Yes *6* No *1*

Participant I-12: The key is how the company organized itself and conducts operations to generate a return to the shareholder.

If NO, please explain :

Participant I-9: Comparability is more important and lends itself to less management "abuse" or manipulation. The problem is how to sort out companies into industry groups without forming too many or too few. Aluminum companies are homogeneous but retailers cover a broad range - wholesalers, supermarkets, department stores, etc.

b. Do you have suggestions for mitigating the effects on comparability of disaggregation based on the way the company views itself and reports internally?

Participant I-9: This is hard to answer without knowing how internal reports differ from each other. For instance, the [name deleted] reports to Directors years ago were designed to prevent anyone from figuring out how profitable the [name deleted subsidiary] partnership was. It was virtually impossible to reconcile internal financial reports with shareholders financial reports. Perhaps there have to be standards that are generally accepted for internal statements.

Participant I-11: In many cases, I think the differences will be small. In any event, I think the value of "comparability" is overstated- the variations in accounting practices between companies can reduce "comparability" enough to make it of little value.

Participant I-12: Most companies in a given business will tend to organize internal reporting systems in a surprisingly similar fashion - ex. all credit card companies track similar info. because it is inherent in the business. As long as information is disclosed, analysts can make adjustments for major discrepancies.

[Also included in 2(c)] **[PMQI 12/9 and 1/13, p. 3]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

At our December meeting we discussed several bases for disaggregating financial information. The following two questions seek your views about four of those bases.

QUESTION 25

At the December meeting, investors ranked highly several bases for disaggregation. Two of those bases were (1) industry, that is, type of product or service provided, and (2) company organization, that is, how the company views itself and reports internally to senior management and the board of directors.

Although the two bases of disaggregation may be similar for some companies, for others they may differ. Consider, for example, the auto industry. Disaggregation based on industry could segment the company into, for example, luxury cars, economy cars, minivans, light trucks and heavy trucks, which may cross lines of internal management. In contrast, disaggregation based on how the company views itself and reports internally could segment the company into divisions, such as Cadillac, Buick, Oldsmobile, Pontiac, Chevrolet, and GMC, each of which produces a variety of products.

If forced to choose between the two methods, which would you choose and why? (Please check your preference and indicate the reason for your choice in the space provided.)

Industry, that is, type of product or service provided, even if products or services cross lines of internal management	*1*
Company organization, that is, how the company views itself and reports internally	*4*

Please describe the reason for your preference.	*Participant I-16:* It would be extremely difficult and perhaps meaningless to attempt to allocate costs in ways that do not correspond to the company's management and control systems. *Participant I-7:* Gives me another checkpoint on how management runs the business and may, in fact, be the reason for company success or lack of it. *Participant I-10*: Better able to compare with general market data. *Participant I-11*: This is a close call, but on balance I think that I will gain more insight from reporting by organization than by type of product or service. Why, for instance, has [one division] been successful and [another division] less , and what implications does that have for [parent's] consolidated profitability. Also, I note that the extraordinarily detailed "industry data" on motor vehicle sales by type is unusual. There's usually far less, and far less accurate, information available on the size and trends of an "industry."

[PMQI 3/17, p. 43-44]

QUESTION 26

At the December meeting, several investors also supported disaggregation based on geographic segment. However, geographic segmentation could be based on at least two methods: (1) the location where products or services are produced, or (2) the location where products or services are delivered or consumed.

3(b). Basis of Disaggregation--Page 29

If forced to choose between the two methods, which would you choose and why? (Please check your preference and indicate the reason for your choice in the space provided.)

Geographic segmentation based on the location where products or services are produced	1
Geographic segmentation based on the location where products or services are delivered or consumed	
A mixed approach that provides some information based on the location where the products or services are produced and other information based on where they are delivered or consumed. For example, disclosures of revenues could be based on the location where products or services are delivered, and disclosures of assets, costs, and expenses could be based on where products or services are produced.	*4*
Please describe the reason for your preference.	*Participant I-16:* The results of the business should be influenced more by the location of the customer (demand, pricing, distribution) than the location of production (manufacturing cost). *Participant I-7:* One gives me a better understanding of the last factors, the other, the revenue factors. *Participant I-11:* If a product is made in Singapore and sold in San Francisco (or vice versa) there are different economic, political, business and accounting issues than if it's made in Singapore and sold in Singapore.

[PMQI 3/17, p. 44-45]

3(b). Basis of Disaggregation–Page 30

Most [CIC] subcommittees agree . . . [that] the following suggestion seems appropriate: [Also included in 1(b), 2(b), 2(c), 3(d), 5(a), 5(d), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3]**

- Segmented financial and operating data, particularly on a quarterly basis, where appropriate both by lines of business and geographic. [Also included in 1(b), 3(d), and 16(b)] **[AIMR/CIC92, p. 3]**

3(c). Types of Disaggregated Information Disclosed

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

- Following is a summary of the principal comments received [on the subject] from users and regulators relating to . . . the needs of users. **[FASOversight, p. 1]**

- Disaggregated or "consolidating" financial information is more meaningful than consolidated financials only. **[FASOversight, p. 2]**

The APC [Accounting Policy Committee] has considered and expresses below its opinions on a number of specific issues affecting financial accounting standards and financial reports. The APC believes that the following [item] should be included in the single body of accounting concepts, standards, principles and methods: **[RMA90, p. 5]**

- For companies that engage in more than one line of business (segment), income from continuing operations should be disclosed for each significant segment. Multinational enterprises should provide disaggregations by geographic location. When significant amounts of revenue emanate from a single customer or related group of customers, that fact should also be disclosed. **[RMA90, p. 7]**

Cash flow analysis [by equity sell-side analysts] displays considerable variety in format and content. Many reports present and/or discuss cash flow extensively. Cash flow information is sometimes presented by segment or operating unit. Some reports make no mention of cash flow at all. Cash flow type phrases occurred about 6,000 times in the full sample. [Separately, dividends are mentioned over 2,000 times.] [Also included in 1(b), 1(c), and 5(c)] **[PREVITS, p. 18]**

To the extent that earnings, earnings momentum and earnings potential drive the equity analytics of sell-side reports, the need for more frequent than annual information on performance is clear, as is the need for more finely disaggregated performance information, in common sized formats to enhance intercompany comparisons. [Also included in 1(a), 2(c), 3(d), and 11(a)] **[PREVITS, p. 21]**

[Context] The following brief summary of the topic "Disaggregated Financial Statements," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

> Analysis of a complex economic entity requires information about the workings of each of its components. There is no disagreement among financial analysts that segment information is totally vital to their work. There also is general agreement among analysts that the current segment reporting standard, ***FAS 14***, is inadequate. Recent work by a subcommittee of the FAPC has confirmed that a substantial majority of analysts seek and, when it is available, use quarterly segment data. [Also included in 3(a) and 3(b)] **[AIMR/FAPC92, p. ix]**
>
> The FASB recently initiated a project on disaggregation for which AIMR is providing partial financial support in addition to its overall endorsement. We do not wish to prejudge the results of research now in its initial stage, but we do suggest an avenue for the FASB's researcher to explore. We believe that segment data are most useful when they depict the way in which the enterprise itself is organized and managed and we urge the FASB to seek ways to promulgate a standard that produces such a result, despite the several difficulties in doing so that we acknowledge and discuss in the report. [Also included in 3(a) and 3(b)] **[AIMR/FAPC92, p. ix]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

> Financial analysts have consistently over the years requested financial statement data disaggregated to a much greater degree than it is now. Most analysts have found the provisions of 1976's Statement of Financial Accounting Standards No. 14, "Financial Reporting for Segments of a Business Enterprise," helpful but inadequate. This situation has been exacerbated by the issuance in 1987 of Statement of Financial Accounting Standards No. 94, "Consolidation of All Majority-Owned Subsidiaries." That statement has the good effect of presenting an overall report on complex economic entities and brings onto the consolidated balance sheet a large amount of debt that previously had not appeared there. Its cost has been the loss of much detailed information about subsidiary operations quite different in character from those of the parent company. [Also included in 3(a)] **[AIMR/FAPC92, p. 39]**
>
> In our previous discussion of quarterly segment reporting we alluded to the needs of analysts for disaggregated financial data. It actually is more than necessary. It is vital, essential, fundamental, indispensable and integral to the investment analysis process. Analysts need to know and understand how the various components of a multifaceted enterprise behave economically. One weak member of the group is analogous to a section of blight on a piece of fruit; it has the potential to spread rot over the entirety. Even in the absence of weakness, different segments will generate dissimilar streams of cash flows to which are attached disparate risks and which bring about unique values. Thus, without disaggregation, there is no

sensible way to predict the overall amounts, timing or risks of an complete enterprise's future cash flows. There is little dispute or controversy over the analytic usefulness of disaggregated financial data. [Also included in 3(b)] **[AIMR/FAPC92, p. 39-40]**

There is much controversy over how disaggregated data should be reported. How shall it be classified: by legal entity, by line of business, by geographic area, by type of customer served, by activity (manufacturing, marketing, etc.), by Standard Industrial Code (SIC) number, or any one of many other possibilities? In what degree of detail shall it be presented? How extensive can detailed disclosures be made before financial statement users are so overcome with minutia that they not only cannot comprehend them, but they also lose sight of the overall portrayal of the enterprise? [Also included in 3(b)] **[AIMR/FAPC92, p. 40]**

Reporting How the Business is Managed

FAS 14 requires disclosure of line of business information classified by "industry segment." Its definition of "segment" is necessarily imprecise and it recognizes that there are numerous practical problems in applying that definition to different business entities operating under disparate circumstances. That weakness in FAS 14 has been exploited by many enterprises to suit their own financial reporting purposes. As a result, we have seen one of the ten largest firms in the country report all of its operations as being in a single very broadly defined industry segment. At the other extreme, there is a publicly-owned provider of funeral services that reports in three segments: funeral services, caskets and other merchandise sales, and cemetery operations. We also are aware of and sympathetic with the problems some enterprises have in collecting and reporting data that conform to FAS 14 categories because their businesses are organized and managed differently. [Also included in 3(a)] **[AIMR/FAPC92, p. 40]**

In an ideal world, an enterprise would report disaggregated data in a format that coincides with and reflects how it is organized and managed. It also would disclose the source and nature of risks that are expected to affect, either positively or negatively, the amounts and timing of its future cash flows. These risks may be associated with geography, product lines, markets, or a variety of other classifications. The enterprise would reveal the boundaries between its assorted legal-entity constituents, thus divulging restrictions on the claims of creditors and movements of cash within the entity. Finally, all of the disaggregated data disclosed would mirror the way the business is organized and managed, while at the same time providing comparability to the disaggregated data of other enterprises. [Also included in 3(b)] **[AIMR/FAPC92, p. 40]**

In the real world, obviously not all of these objectives can be achieved. They require trade-offs and choices. From the standpoint of financial analysis, we believe priority should be given to the production and dissemination of financial data that reflects and reports sensibly the operations of specific enterprises. If we could obtain reports showing the details of how an individual business firm is organized and managed, we would take more responsibility on ourselves to make meaningful comparisons of those data to the unlike data of other firms who conduct their business differently. We realize the extraordinary difficulty of mandating a disclosure standard while maintaining the flexibility of each enterprise to present its own circumstances and organization, but we believe it to be a commendable undertaking. [Also included in 2(c) and 3(b)] **[AIMR/FAPC92, p. 40]**

Research in Progress and Prognosis for Change

Those are questions that we anticipate will be addressed and answered in a research study on "Disclosure of Disaggregated Information" launched by the FASB in the first quarter of 1992. This topic is so important to AIMR that it has contracted with the FASB to provide partial funding to support this important research project. We envision that the project will culminate in an FASB discussion memorandum in which the views of all parties, including those of financial analysts, will be presented in a neutral and comprehensive manner for consideration by the entire financial community. **[AIMR/FAPC92, p. 41]**

We urge the FASB to move the disaggregation project along at all due speed. It sometimes seems as if the projects which promise to produce information of greatest use to financial analysts are the most interminable. There is no reason for further delay or procrastination in giving attention to this subject by: (a) standard setters, the FASB and the IASC as well; (b) capital market regulators, the SEC and IOSCO; (c) the accounting profession, the AICPA as well as the International Federation of Professional Accountants. **[AIMR/FAPC92, p. 41]**

Consolidating Financial Statements

Although we support the requirement that consolidated financial statements be the basis for general purpose financial reporting, we lament the concomitant loss of detailed information about an economic enterprise's constituent corporate entity components. Currently, published summary data on consolidated subsidiaries are insufficient for analysts to be able to deconsolidate them with sufficient assurance of accuracy. We seek the best of all worlds: consolidating financial statements. Complex entities often prepare these for use by lenders. Since the issuance of FAS 94, a small number of companies have even included them in their published financial reports. There seems to be little reason why they could not be required of all companies. The cost to prepare them would be trivial, except perhaps for additional audit fees caused by a lower materiality threshold. We urge the FASB to consider requiring them. **[AIMR/FAPC92, p. 41]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the preliminary discussion on the objectives and approaches of investors and the types of information they use, some investors made comments pertinent to the basis of disaggregated information.

Participant I-6

Coming back to cash flow, I think it's important but I don't think you can get there without earnings. If we're going to have true segment disclosures, earnings are nice but with a diversified company that is in coal mining, gold mining, natural gas and manufacturing, how about having cash flows by segments too? Cash flow is an important piece of the equation, but if you don't have it by segment, you're deceiving yourself if you think you're forecasting. [Also included in 1(b)] **[TI 10/16, p. 22]**

Participant I-11
I join the chorus on segment accounting. We could do with much more consistent and detailed segment accounting on a quarterly basis. At least two diversified companies that I know establish the segments they report in a manner totally separate from the method in which they run their business and it's clear they're just trying to obfuscate things. I can't find any justification for that. [Also included in 1(b), 3(a), and 3(d)] **[TI 10/16, p. 22]**

Participant I-9
I don't think it's worth the costs for the companies I follow to have segment reporting on a quarterly basis. What I would ask is that it be consistent from year to year. With respect to pharmaceutical, for example, if you switch a drug from the ethical sector to the over-the-counter sector, make some sort of adjustments in the figures of the prior years so we can look at the trends on that. I go back to the point about what the auditor should look at for a particular industry. With respect to pharmaceutical, the companies are now showing price increasing data; it would be nice to have an auditor to say whether that data is reasonable. Research is also a big item; why not segment out what is basic research from research on drugs and give the FDA categories (phase 1, phase 2, and phase 3 breakdowns)? The other problem in the area is that companies are international; for example, [name deleted] has 40% of its business in the U.S. and is headquartered in London. You convert the U.S. earnings to British accounting and then reconvert it back to ADRs and you can get two reports that have to be reconciled for a company that is half in the U.S. and half abroad. And you will have more problems with the Swiss companies. The other problem is marking to market on currencies. We don't understand the accounting standards. Those areas call for particular expertise where accountants could be very helpful. [Also included in 1(b), 3(d), and 17(b)] **[TI 10/16, p. 23-24]**

Committee/Staff/Observer
This relates again to financial information, but financial information that is not required in external reporting. What additional financial information do you regularly use that is not part of external reporting? [Also included in 1(b)] **[TI 10/16, p. 44]**

Participant I-11
Sale and profit information by product line or product category. [Also included in 1(b)] **[TI 10/16, p. 45]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information.

Participant I-7
I accept differences, even in the same business, for the companies that I look at. The quality that I demand is information. I want the information so that I can understand those differences and make as clear an interpretation as I possibly can. On my side, I will tell the company that there is information that we, in the public eye, should not receive; union information, early pricing, product strategies, new products, and the like. But there isn't a medium to large size

company that doesn't know what their competitor does within a very reasonable order of magnitude. And any analyst around this table will tell you that you tend over time to find out more about a company from the competition than from the company itself. [Also included in 2(c) and 3(b)] **[TI 12/9, p. 7]**

Committee/Staff/Observer
We want to discuss the types of information that should be reported within each of the bases. For example, consider disaggregated information based on industry segments. As you know, under today's rules, companies report certain summarized information such as revenues, operating profit, identifiable assets, depreciation, and capital expenditures. Our question is whether you are satisfied with the level of information currently reported or whether you believe that companies should report additional information. If you are not satisfied, what additional types of information do you want or that companies should report? **[TI 12/9, p. 21]**

Participant I-12
The critical information that you need is the revenues, the expenses, after tax income, assets and liabilities. There is a very large number of companies that have gotten into financial related businesses and that are taking on a certain amount of financial risk; some measure of that risk needs to be available. Personally, I would go into enormous detail on this. **[TI 12/9, p. 21]**

Participant I-7
I would like to see segment net profit. Allowing the segment information to stop at the operating profit line and not showing me things like interest expense is not terribly useful. Order backlog by segment is important in the electrical equipment industry because the backlog can stretch out for a long period of time (for example, in the nuclear industry, for as much as 8-10 years). **[TI 12/9, p. 21]**

Participant I-8
I can't imagine everybody here wouldn't want all the information listed on page 8 of the meeting materials, to the exception perhaps of the number of employees by segment. **[TI 12/9, p. 22]**

Participant I-7
But that would give you productivity. **[TI 12/9, p. 22]**

Participant I-8
The per-share segment data, we could do the arithmetics for that one. **[TI 12/9, p. 22]**

Participant I-11
I think you run into problems when you carry segment information down below the operating profit line. In some cases, it's very clear where capital comes from and where it goes; in other cases, it's not clear at all. I'm not sure that I would want management to allocate costs to segments below the operating profit line. **[TI 12/9, p. 22]**

Participant I-6
I'm almost in [participant I-11] camp. I'm not sure I would like the segment information to go beyond the operating profit level. I'm not sure it's very helpful unless you require companies every year to tell us how they allocate corporate costs, so we know if they have been consistent every year. I use the corporate number basically as a catch-all to compare the efficiency of corporate headquarters. **[TI 12/9, p. 22]**

Participant I-7
I don't understand why allocating overheads would be a problem; it's done routinely as part of management's cost accounting. **[TI 12/9, p. 22]**

Committee/Staff/Observer
I think what people are saying is that there is such discretion in that allocation that the number below operating profit may not be meaningful. I'm not saying I agree or disagree. **[TI 12/9, p. 22]**

Participant I-11
I think it's a problematic number. **[TI 12/9, p. 23]**

Participant I-12
What I would like to know is which costs are being allocated versus costs that are directly attributable to a segment. I would also like to see the capital used by a business segment because I'm interested on return on investment or capital. **[TI 12/9, p. 23]**

Participant I-7
If you're not allocating the costs properly, you're not charging the customer properly. I want to see the information even if it does nothing more than forcing the company to allocate costs properly. **[TI 12/9, p. 23]**

Committee/Staff/Observer
It was mentioned at the last meeting, but nobody has mentioned production information by segment. **[TI 12/9, p. 23]**

Participant I-6
I made that plea last time; I want the information. **[TI 12/9, p. 23]**

Committee/Staff/Observer
What about if too much segment disclosure affect the company's competitive position? Where do you draw the line? Is that an issue? **[TI 12/9, p. 23]**

Participant I-7
If a competitor wants to know, he will find out. I believe there is certain advanced information (dealings with the unions, pricing strategies, new product strategies) that does not belong to the public until the company decides to make the information public. **[TI 12/9, p. 23]**

Participant I-8
When you ask companies for additional information, 99 times out of a 100 they tell you they don't want to disclose it for competitive reasons, which I don't accept. The one good reason could be if you have a very profitable operation and you don't care to have your customers know how much money you're making on that product. **[TI 12/9, p. 23-24]**

Participant I-12
I heard this argument for years from brokerage firms and I think the only reason they don't want to disclose the information is because they don't know. That bothers me as an investor; it does not make me confident. The accounting rules are flexible enough that there is enough room to aggregate the information in a way that is reasonable while keeping truly proprietary information where it belongs. **[TI 12/9, p. 24]**

Participant I-13
In the industry that I cover, there is no competitive disadvantage because all companies are dealing on the public precious metal markets. So I would like as much information as possible, from revenue to detailed cost to profit by operating unit. **[TI 12/9, p. 24]**

Participant I-12
In terms of format, there are certain items that I would like to see. I would like to know how much of the costs, and in some cases revenues, are on allocated (or discretionary) basis as opposed to directly attributable to the business, because those allocations can really make a massive difference. As long as I know what the number is, then I can determine whether or not it is appropriate. [Also included in 3(e)] **[TI 12/9, p. 25]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of disaggregated information.

Committee/Staff/Observer
What type of [segment] information would you want to see [in interim reports]? [Also included in 3(d) and 11(c)] **[TC 12/8, p. 38]**

Participant C-13
Same as annual. [Also included in 3(d) and 11(c)] **[TC 12/8, p. 38]**

Participant C-10
On your list we've got backlog and I wrote "heavy" next to that, in other words heavy use, I put a big emphasis on that. Some companies don't have much backlog, it's almost a daily order business. It varies from company to company, and then sometimes by type of product line; one type of product line would have a heavy backlog because of its link to the construction nature, like your production contracts. That's a short term piece of information, but very helpful to understand how your company is going, especially its liquidity. [Also included in 1(b) and 13] **[TC 12/8, p. 51-52]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 6

Regardless of your choice of the basis of disaggregation, please indicate below your preference for disclosure of disaggregated components.

Indicate E - Essential,
P - Preferred but Not Essential, or
N - Not Normally Needed

<u>Disaggregated Disclosure Components</u>

E	P	N			
15		1	__	a.	Revenue
12	3	1	__	b.	Gross Profit
13	3		__	c.	Operating Profit
4	10	2	__	d.	After-tax Profit
2	11	3	__	e.	All Income Statement Components
12	4		__	f.	Total Assets
10	5	1	__	g.	Total Liabilities
5	8	2	__	h.	Working Capital
4	10	2	__	i.	Net Assets
1	10	5	__	j.	All Balance Sheet Components

14 2 ___ k. Cash Flow from Operations
7 7 2 ___ l. Cash Flow from Financing Activities (Borrowings & Stock Transactions)
7 7 2 ___ m. Cash Flow from Investing Activities (including capital expenditures)
6 5 4 ___ n. All Cash Flow Statement Components
___ o. Other:
___ p. Other:

Participant C-4 - Other categories: Management responsibility - in organization chart form that matches with the segments. Historic Results.

Participant C-18 - If you're going to do it - provide complete information

Participant C-11 - To some extent, this will depend on the type of industry.

Participant C-13- Other categories: Capital expenditures.
[PMQC 12/8, p. 16-17]

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 3

a. Regardless of your preference of the basis of disaggregation, please indicate below your preference for disclosure of disaggregated components.

Indicate E--Essential
P--Preferred but Not Essential, or
N--Not Normally Needed

Rank E, P, or N

	Essential	Preferred but Not Essential	Not Normally Needed
a. Revenue	*7*		
b. Gross Profit	*6*	*1*	
c. Operating Profit	*7*		
d. After-tax Profit	*4*	*2*	*1*

3(c). Types of Disaggregated Information Disclosed--Page 11

e. All Income Statement Components *Participant I-12*: I would suggest KEY components only 3-4 items	*1*	*4*	*2*
f. Total Assets	*2*	*5*	
g. Total Liabilities	*3*	*4*	
h. Working Capital	*1*	*5*	*1*
i. Net Assets	*2*	*2*	*3*
j. All Balance Sheet Components		*5*	*2*
k. Cash Flow from Operations	*5*	*2*	
l. Cash Flow from Financing Activities	*2*	*5*	
m. Cash Flow from Investing Activities	*3*	*4*	
n. All Cash Flow Components	*2*	*4*	*1*
o. Other *Participant I-12*: Average balance sheets for <u>any</u> lending operation	*1*		
p. Other			

b. Are there any segment disclosures listed above or any other segment disclosures that you would like to obtain that could harm a company's competitive position (vis-a-vis its domestic competitors who would report the same information or vis-a-vis its foreign competitors who would not have to report that information) if disclosure was required?

Yes *4*
No *3*

If YES, which ones?

Participant I-7 Market share
Participant I-9 Gross profit, Operating Profit, Cash flow from operations
Participant I-10 Wage costs, R&D, advertising expenses
Participant I-11 Maybe some harm from financing, investing data. Companies will claim P&L data will cause harm- I seriously doubt that in most cases.

[PMQI 12/9 and 1/13, p. 4-5]

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 4

b. At the meeting, participants made a number of specific suggestions related to some disaggregated disclosures. Please indicate your views on the following suggestions.

3(c). **Types of Disaggregated Information Disclosed--Page 12**

Indicate A--Agree with the proposed disclosure
D--Disagree with the proposed disclosure
P--Proposed disclosure preferable but not essential

	Agree	Disagree	Preferable but not essential
i. Separate disclosure within the disclosure made for each segment of the effect of discontinued operations	*5*	*1*	*1*
ii. Multi-column consolidating financial statements if a financial subsidiary is consolidated in accordance with the requirements of FAS 94	*5*	*1*	*1*
iii. Multi-column consolidating financial statements in other cases. Please specify.		*4*	*2*
iv. Multi-column consolidating cash flow statement in all cases that consolidating statements are disclosed	*5*	*1*	*1*

	Agree	Disagree	Preferable but not essential
v. Other. Please specify *Participant I-12*: Consolidating statements are useful, but half the fun of being an analyst is tracking down discrepancies between segment disclosure and the official statements. Reasonable segment disclosure with a single line to reconcile to the total is usually sufficient for a good analytical job.		✓	

[PMQI 12/9 and 1/13, p. 6]

[An] example [by the Georgia-Pacific Corporation] of . . . disclosure that address[es] one the most important needs of the investor; concise and complete segment information. In its 1991 annual report to shareholders, Georgia-Pacific Corporation presented a breakout of sales and operating profit in 13 different forest product sectors. The breakout not only provides current year numbers but also equivalent data for each of the preceding ten years. [Also included in 1(b)] **[AIMR/CIC92, p. 4]**

Consolidation (Statement No. 94) theoretically may be the correct answer, but for many users the destruction of the financial data base far exceeds any advantage of having consolidated statements. A few major corporations have understood the problem and are providing separate supplementary financial statements or consolidating financial statements in their annual reports. The user can only hope that more managements will understand the importance of the loss of the disaggregated information and provide it on an annual and quarterly basis. We also encourage the FASB to expedite its review of FAS No. 14, Financial Reporting for Segments of a Business Enterprise. [Also included in 2(c)] **[AIMR/FAF91, p. 11]**

Analysts were able to identify many areas in which they believed expanded disclosures would be useful, but most of those had little or no relation to fair value information. The disclosures they were most interested in were: [Also included in 3(e), 5(b), 10(c), 13, and 17(f)] **[KPMG BANK STUDY, p. 38]**

- Detailed disclosures of operating income and expense by operational segment [Also included in 3(e), 5(b), 10(c), 13, and 17(f)] **[KPMG BANK STUDY, p. 38]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

Financial statements are imperative for [one analyst] in her work. Her main complaint is that banks should report their revenues and expenses by lines of business (segments). She does not like market value accounting; she feels it will lead to behavioral disadvantages, such as the shortening of the maturities of portfolios. Furthermore, earnings would become far too volatile. She can read the footnotes to find out what she wants to know about market values. [Also included in 1(b) and 4] **[GOLDMAN, p. 1-2]**

From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 1(b), 2(c), 2(d), 4, 5(a), 5(c), 6, 8(a), 9, 11(b), 11(c), and 15] **[BETRIOU, p. 1]**

- Breaking down business, profit and main items of the balance sheet per origin (geographical zones and business segments). This type of data which could be limited to a few major elements of the profit and the balance sheet is still too often unavailable. [Also included in 1(b) and 15] **[BETRIOU, p. 2]**

  The publication of the profit/loss of the main divisions of a group is also desirable, especially when they have appreciably different margin ratios (moreover, when some lose money). This data is in fact particularly useful for examining the development of the total profit. [Also included in 1(b) and 15] **[BETRIOU, p. 2]**

3(d). Frequency of Segment Reporting

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to . . . the needs of users. **[FASOversight, p. 1]**

- Quarterly segment information would improve the value of quarterly financial information. **[FASOversight, p. 2]**

To the extent that earnings, earnings momentum and earnings potential drive the equity analytics of sell-side reports, the need for more frequent than annual information on performance is clear, as is the need for more finely disaggregated performance information, in common sized formats to enhance intercompany comparisons. [Also included in 1(a), 2(c), and 11(a)] **[PREVITS, p. 21]**

Quarterly Segment Reporting (QSR)
The topic of disaggregation is sufficiently important to merit its own separate discussion in the next part of this report. Here we wish to discuss only the need for disaggregated information to be provided more frequently than it is currently. Quarterly segment reporting (QSR) is a topic that has been advocated by analysts so consistently and so avidly over so many years that it has acquired its own acronym. In 1990, the AIMR Financial Accounting Policy Committee surveyed member analysts in the United States and Canada who responded overwhelmingly in favor of mandated quarterly segment reporting[12]. Not only do analysts need financial reports as frequently as every three months, they need them in vastly more detail than is mandated today. Some companies do an excellent job in presenting segment data; others offer only the bare minimum disclosures required. We seek a much higher standard to apply to the latter. [Also in 11(a)] **[AIMR/FAPC92, p. 37-38]**

It is the unusual publicly-owned company that today operates with a single line of business or in a single geographical area. All others requires analysis of their separate parts before an assessment can be made of their value as a whole. It is absolutely necessary for analysts not to have to wait for a full year to discover, for example, that a manufacturer of heavy equipment suffered major losses in Latin America earlier in the year. Or, that a manufacturing operation

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[12] A summary of the survey results may be obtained by requesting it in writing from: Association for Investment Management and Research, 200 Park Avenue, 18th Floor, New York, NY 10166.

has been losing money, a fact concealed by the excessively good results of its finance operations. These data must be made available more frequently than is required now. [Also in 11(a)] **[AIMR/FAPC92, p. 38]**

[Context] The AIMR report's introduction to the section entitled "Summary of Important Positions and Guide to Future Actions" begins and ends as follows:

> Much of this report relates to the present state of the art and implications for future developments in financial reporting. Righfully, so do most of the positions stated in this section . . . [T]hey all build on positions taken by AIMR in the past . . . [Also included in 1(b), 1(d), 4, 5(a), 8(c), 11(a), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 59]**
>
> We expect the positions set forth below to build on the precedents of the past. That does not prevent them from breaking new ground, but they do not introduce significant inconsistencies with previous AIMR positions. To the extent that they do establish new stances those are largely the result of the changing world that we describe earlier in this report. [Also included in 1(b), 1(d), 4, 5(a), 8(c), 11(a), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 60]**

Those two paragraphs introduce the following summary of a position taken by the Committee.

> Provide Frequent and Detailed Financial Reports
> Interim financial reporting requirements in this country have been the subject of much unjust criticism. They have been blamed for everything from "short termism" to a degradation in U.S. competitiveness. Not only are those charges without merit, they also fail to credit interim reporting for its vital role in keeping investors informed, diminishing opportunities for trading on privileged information, and maintaining peak efficiency of the financial markets. We believe we present in this report and elsewhere[27] valid reasons to continue mandated quarterly financial reporting. [Also included in 1(d) and 11(a)] **[AIMR/FAPC92, p. 63]**
>
> One of the primary deficiencies in contemporary financial reports is the minuscule amount of disaggregated data. In annual reports, that which is provided usually is skimpy and many firms have interpreted the provisions of FAS 14 so as to report fewer segments than an analyst might expect, and sometimes segments are defined by the firm in peculiar ways. Not only are we in urgent need of new definitions and disclosure requirements to emanate from the newly-inaugurated FASB project on disaggregation, we also need segment reporting extended to interim reports. Analysis of a complex enterprise with diverse operations is futile in the absence of significant quantities of disaggregated financial data. [Also included in 1(d) and 11(a)] **[AIMR/FAPC92, p. 63]**

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[27] Korn, *op. cit.* [The Need for Quarterly Financial Reports from Publicly Owned Companies: A response to the Competitiveness Debate (AIMR, 1992).]

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the preliminary discussion on the objectives and approaches of investors and the types of information they use, some investors made comments pertinent to the frequency of segment reporting.

Participant I-7
We don't get good FAS 14 disclosure in the annual report and we get less from most of our companies in the quarterly reports. FAS 14 is just an abomination at least in my industry from a quarterly point of view. I also heard the argument about the expense of creating this information. There isn't a reasonable size company that doesn't have internal reporting and the people inside the company get a report card, if not monthly certainly quarterly, and that's the kind of information that is readily available that I would like to see. One of the things that should be discussed somewhere is: what the information that we as outside investors should not be permitted to get from a competitive point of view? They all know internally what their competitors are doing and yet they don't want to provide certain information to us for competitive reasons. It's vital that the accounting profession decide what kinds of information are competitively harmful and others that aren't. [Also included in 1(b), 2(d), 3(a), 3(b), and 11(c)] **[TI 10/16, p. 21]**

Participant I-11
I join the chorus on segment accounting. We could do with much more consistent and detailed segment accounting on a quarterly basis. At least two diversified companies that I know establish the segments they report in a manner totally separate from the method in which they run their business and it's clear they're just trying to obfuscate things. I can't find any justification for that. [Also included in 1(b), 3(a), and 3(c)] **[TI 10/16, p. 22]**

Participant I-9
I don't think it's worth the costs for the companies I follow to have segment reporting on a quarterly basis. What I would ask is that it be consistent from year to year. With respect to pharmaceutical, for example, if you switch a drug from the ethical sector to the over-the-counter sector, make some sort of adjustments in the figures of the prior years so we can look at the trends on that. I go back to the point about what the auditor should look at for a particular industry. With respect to pharmaceutical, the companies are now showing price increasing data; it would be nice to have an auditor to say whether that data is reasonable. Research is also a big item; why not segment out what is basic research from research on drugs and give the FDA categories (phase 1, phase 2, and phase 3 breakdowns)? The other problem in the area is that companies are international; for example, [name deleted] has 40% of its business in the U.S. and is headquartered in London. You convert the U.S. earnings to British accounting and then reconvert it back to ADRs and you can get two reports that have to be reconciled for a company that is half in the U.S. and half abroad. And you will have more problems with the Swiss companies. The other problem is marking to market on currencies. We don't understand the accounting standards. Those areas call for particular expertise where accountants could be very helpful. [Also included in 1(b), 3(c), and 17(b)] **[TI 10/16, p. 23-24]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information.

Participant I-7
If the company in the annual report reports on a FASB 14 basis, the SEC should insist that they do so on the same basis in the quarterly reports. [Also included in 3(e)] **[TI 12/9, p. 24]**

Committee/Staff/Observer
. . . [S]hould segment disclosures be required in interim reports? If so, should the interim segment disclosures be the same as in the annual report, less extensive, etc? **[TI 12/9, p. 26]**

Participant I-12
Yes. **[TI 12/9, p. 26]**

Participant I-6
I think they should be required every single quarter. They should be more thorough than they currently are. I do the information every quarter in my industry; we need better disclosure every quarter. **[TI 12/9, p. 26]**

Participant I-12
I believe we need quarterly segment disclosure in order to understand a business. But there is also the issue of cost for preparers of the information. In some cases, the cost can be quite high; in other cases, companies have the data available as part of their management information and it's not costly. **[TI 12/9, p. 27]**

Participant I-6
This goes back to [participant I-7] earlier point; give us the information as you manage the company. If you do that, you have the data available every quarter. [Also included in 3(b)] **[TI 12/9, p. 27]**

Participant I-9
I can see how for [participant I-12] industry it would be crucial. For the industries I am most familiar about, health care and retailing, I don't think it's that necessary. If the quality of the data drops off, then it's counterproductive. If a business doesn't have a rapid rate of change, you are not going to have dramatic changes from quarter to quarter. If you did it in retailing, the retailers would fudge the numbers. If you do it well (segment reporting) once a year, then it's better than having quarterly statements prepared on a less reliable basis. **[TI 12/9, p. 27]**

Participant I-11
I don't agree with [participant I-9] on that. I am an advocate of having management report to me the way they manage their business. They have that information; the cost argument doesn't hold. And if they don't have it, then they're lousy managers and maybe I'm helping them out by forcing them to get the information together. [Also included in 3(b)] **[TI 12/9, p. 27]**

Participant I-9
But do they have the information? If you're closing the books of your Thailand subsidiary at a different time than you do the ones in Germany and U.K., isn't it a burden to ask them to do this four times a year instead of one? **[TI 12/9, p. 27]**

Participant I-11
I hope they have their acts together more than four times a year. **[TI 12/9, p. 27]**

Participant I-12
[Name deleted] has an extensive international operation and they report on the 9th day of the month at the end of the quarter. What they've done is to close their books internationally slightly earlier than they do domestically. The first time they did it, all the numbers were off, but the next time you had reasonable comparability; it's not like they close the books internationally in the middle of the quarter. **[TI 12/9, p. 28]**

Participant I-9
But for a lot of businesses, I think it's much more of a problem than for [name deleted] and I don't think it's that relevant. **[TI 12/9, p. 28]**

Participant I-8
Once you're organized to do it once a year, I don't see why you can't do it four times a year. **[TI 12/9, p. 28]**

Participant I-7
I follow a group of manufacturing companies and they range in size from $300 million to $65 billion. By the 10th of every month (it's true that the foreign operations lag by 30 days but they're included on a lag basis) this information is available to the chief executive and the chief financial officer. And if it isn't, I don't want to follow the company. **[TI 12/9, p. 28]**

Participant I-9
Just looking at the research department of our shop. Once a year, I'll do a cost allocation for the branch offices; if I'm forced to do it quarterly, I'm not going to do it with the same intensity and with the same precision. What I'm arguing about is how well it's going to be done. **[TI 12/9, p. 28]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting. During the discussion, comments were made on the frequency of segment reporting.

Participant I-7
I'd like to make an appeal here that any company that has more than one business and that doesn't produce FAS 14 disclosures should be significantly penalized. [Also included in 11(c)] **[TI 3/17, p. 41]**

Committee/Staff/Observer
Does the market already penalize those companies? [Also included in 11(c)] **[TI 3/17, p. 41]**

Participant I-7
I would say that the penalty ends up on the bottom line of the company. In the industry that I follow, one out of 8 companies produces FAS 14 information and it does not get a higher valuation because of a lack of consistency in operating or profit performance, even though they give more information than the other 7 companies. [Also included in 11(c)] **[TI 3/17, p. 41]**

Participant I-12
In my industries, my observation has been that whenever a company begins to provide segment detail, the valuations do go up after a year and they stay up. I think the reason for that is that it provides clarity of what's going on in the company and consistency between the way management talks about its businesses and run them and what we analysts see and are able to track. [Also included in 11(c)] **[TI 3/17, p. 41-42]**

Participant I-7
In my industry, clarity without performance doesn't buy anything in terms of incremental value. [Also included in 11(c)] **[TI 3/17, p. 42]**

Committee/Staff/Observer
[Participant I-12], is that because the companies that are providing such information are the stronger companies? [Also included in 11(c)] **[TI 3/17, p. 42]**

Participant I-12
Yes, they wouldn't provide it otherwise. [Also included in 11(c)] **[TI 3/17, p. 42]**

Participant I-7
In my industry, the strongest companies don't provide that information. [Also included in 11(c)] **[TI 3/17, p. 42]**

Participant I-12
It comes back to the old saying that if you don't provide the information, it means one of two things: either you don't know, which is scary, or you're afraid to, which is even scarier. Both conclusions are negative. [Also included in 11(c)] **[TI 3/17, p. 42]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of disaggregated information.

Participant C-13
I think the pressure from the investment community on disaggregated information has been strong on the business community, and relatively successful, with one glaring exception, and that's interim segment information. And as a result, my answer to [committee/staff/observer] question would be that I think that at this point establishing core earning power is maybe more critical. [Also included in 11(c) and 15] **[TC 12/8, p. 27]**

Committee/Staff/Observer
FASB statement 14 requires disaggregated information only in annual statements. Should disaggregated information be required in interim statements as well? [Also included in 11(c)] **[TC 12/8, p. 37]**

Participant C-13
Absolutely yes. I and many users feel quite strongly on this issue. There is significant evidence that there is material information content in quarterly reports. Therefore, if any kind of disaggregated information is important, it's also important in interim statements. And the volatility of results and the practice of companies of buying and selling divisions makes it imperative that on an interim basis you're able to analyze firms on disaggregated basis. [Also included in 11(c)] **[TC 12/8, p. 37]**

Committee/Staff/Observer
What type of information would you want to see on that? [Also included in 3(c) and 11(c)] **[TC 12/8, p. 38]**

Participant C-13
Same as annual. [Also included in 3(c) and 11(c)] **[TC 12/8, p. 38]**

Participant C-12
As strongly as I feel about getting disaggregated information, I think I can live without it on a quarterly basis, unless there is a major change. [Also included in 11(c)] **[TC 12/8, p. 38]**

Participant C-13
Well, when there's a major change, you need to have had it reported. [Also included in 11(c)] **[TC 12/8, p. 38]**

Participant C-12
I'm not sure how you enforce that. Otherwise quarterlies are getting bigger and bigger, and I'd just as soon leave something out. [Also included in 11(c)] **[TC 12/8, p. 38]**

Participant C-15
I'm not even sure if companies would physically be able to compile market shares and so on on a quarterly basis? [Also included in 11(c)] **[TC 12/8, p. 38]**

Participant C-13
Well, they're not required to present market share information even on an annual basis. But my contention would be that if a company is not reporting to its board of directors at least on a quarterly basis, and I'll bet virtually every major company reports monthly to its board of directors, then it's not being properly managed. So the information is available. [Also included in 11(c)] **[TC 12/8, p. 38]**

Participant C-12

I would much rather have them do more on an annual basis. Because if I look at [name deleted] today, I'd like them to do a product cut for me, a geographic cut, a legal entity cut. And I don't know that I want all that quarterly, but each of those has some meaning, at least. [Also included in 3(b) and 11(c)] **[TC 12/8, p. 38-39]**

Participant C-1
Part of that may be a difference, though, between companies that have heavy seasonal emphasis and companies that don't. For companies with seasonal emphasis, which is most industrial or retailers, the ability to get quarterly numbers is very important by segments. I think the rule for non-financial institutions is that quarterly statements are important, and that there is seasonality to them, and there is differences in the way these divisions or business segments report. And I don't know if you need as much detail as you get in the annual, but the ability to at least be able to determine operating income and revenues is important. [Also included in 11(c)] **[TC 12/8, p. 39]**

Participant C-13
The reason why I say that you should have the same as in the annual reports is that the minimum statutory requirement for annual reporting is not particularly onerous. Now maybe it should be better, but I think on an interim basis we should get at least what's currently required as a minimum for annual statements. [Also included in 11(c)] **[TC 12/8, p. 39]**

Participant C-11
I was just going to strongly reinforce what [participant C-13] said. I think in every aspect of business, not just seasonal sales, there are so many changes that go on during a year, interest rate trends and so forth, that if you don't know what's going on in different environments, you just don't know anything. [Also included in 11(c)] **[TC 12/8, p. 39]**

Participant C-4
I think that investors would probably want a lot more frequent information. For creditors, though, their obligations are a lot more long term in nature. And I think the purpose of accounting is to analyze an entity over an operating cycle. And to disclose too much information in an interim period may cause a lot of volatility in the markets, may cause a lot of panic, or discussion that may not be necessary. If we're in touch with our customers and we have open communication, we can get a lot of that information from them I'm all for improving year end segment reporting or operating reporting, and focusing on the full operating cycle rather than quarterly. [Also included in 11(c)] **[TC 12/8, p. 39-40]**

Participant C-13
Just an observation or rebuttal, if I may. There is academic literature that shows that quarterly reporting reduces volatility. There are fewer year end surprises. [Also included in 11(c)] **[TC 12/8, p. 40]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 7

FASB Statement 14 requires disaggregated information only in annual statements. Participants did not seem in agreement on the need for interim disaggregated information. Please consider the following:

If interim disaggregated information was provided:

	YES	NO
I would use it		
i. All the time to update my credit analysis	4	
ii. All the time, but only to identify "changes"	7	
iii. Occasionally, but not always	3	
iv. Rarely	2	
v. Never, because interim information is too volatile		

Participant C-12 - Occasionally, but not always because interim information is too volatile.

Participant C-18 - In my view, not cost justified to produce this, given limited value.

Participant C-11 - Only one person said he was overloaded and would be happy with annual. If you analyzed his actual work procedures and the requirements of his job, you'd get a different answer, I suspect.
[Also included in 11(c)] **[PMQC 12/8, p. 17-18]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting. During the discussion, a comment was made on segment reporting.

Participant C-13
I also picked core earnings as one of my three. I'm not sure that we need specific rule changes but improved disclosure under existing rules would probably be adequate. Secondly, I chose interim reporting because I think a rule change for a reporting segment would be a major

step forward. And thirdly, I chose number thirteen, off balance sheet financing and hedge accounting. I think practice is ahead of theory in this sphere and we need some codification. [Also included in 11(c), 15, and 19] **[TC 3/11, p. 69]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 5

a. FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, requires disaggregated information only in annual statements. At the December 9 meeting, a majority of participants were in favor of obtaining quarterly disaggregated information. Do you need quarterly disaggregated information?

Yes *6*	No *1*

Comments:
Participant I-6: Very important.

Participant I-7: Where not available, company (multi-industry) has too much latitude in its once a year presentation

Participant I-8: Unfortunately the institutionally dominated market has excessively heightened emphasis on short term results.

Participant I-9: Sure, I would like it but this is asking too much of most companies to require it.

Participant I-12: Earnings forecasts are built on a quarterly basis and typically reflect the factors that make or break earnings, which are line of business results

b. If quarterly segment disclosures were made, would you want:	
The same level of detail as is currently reported in annual statements under Statement 14? *Participant I-12*: Let's be consistent.	*3*
The information marked E (Essential) in question 3(a)? *Participant I-9*: Perhaps an abbreviated segment report is the answer.	*4*
The information marked P (Preferred but Not Essential) in question 3(a)?	*1*
Comments	

c. If quarterly disaggregated information were provided, would you use it:	
All the time? *Participant I-12*: I do now for earnings models, although the quarterly info. is only my estimates.	*4*
Occasionally, but not always? *Participant I-9*: I would always look at it. It would put me on notice of changes in the business and/or finances.	*3*
Rarely?	
Never, because interim information is too volatile?	

[PMQI 12/9 and 1/13, p. 7]

Most [CIC] subcommittees agree . . . [that] the following suggestion seems appropriate: [Also included in 1(b), 2(b), 2(c), 3(b), 5(a), 5(d), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3]**

- Segmented financial and operating data, particularly on a quarterly basis, where appropriate both by lines of business and geographic. [Also included in 1(b), 3(b) and 16(b)] **[AIMR/CIC92, p. 3]**

3(e). Other

Professional investors want as much detail from annual reports as they can get. When asked to choose 10 different ways in which annual reports could be useful to them, professionals gave the alternative "disclose as many details and numbers as possible" an 84 percent rating, second only to organizing the report using a business segment format . . ., which had a 91 percent rating. [Also included in 1(b)] **[HILL KNOWLTON, p. 9]**

[P]rofessional investors place a high value on business segment information in annual reports. [Also included in 1(b)] **[HILL KNOWLTON, p. 9]**

[P]rofessionals ranked the item "present the business in a segment-by-segment format" first among the 10 ways in which annual reports could be most useful to them, giving it a 91 percent rating. And in rating the importance of various information items in the annual report, professionals placed business segment information second, with a 93 percent rating, right behind the report's financial statements, which had a 95 percent rating. [Also included in 1(b)] **[HILL KNOWLTON, p. 10]**

[P]rofessional [investors] . . . said that they are interested in long-range forecasts by segment, and that they feel companies sometimes manipulate segment data to obscure, rather than inform. [Also included in 12] **[HILL KNOWLTON, p. 10]**

A standard, if somewhat simplified, approach taken by most analysts in forming recommendations is as follows. Disaggregate the company's operations into as fine a set of operating units as possible and develop earnings forecasts for each unit. This reduction is much finer than GAAP. For example one report commented that a company "reports two lines, but there are actually three". Analysts regularly discuss the above matters with respect to each operating unit. For example, one waste removal company was analyzed by individual landfills; a gaming company was analyzed by individual casinos, etc. [Also included in 1(a), 1(b), and 1(c)] **[PREVITS, p. 12]**

In the same way, operating revenues and expenses are often assessed [by equity sell-side analysts] for individual segments of a company. Performance analysis by significant product or individual location is common. For example, analysts may evaluate the performance of hotel companies in terms of specific U.S. or international geographic regions, or even specific hotels, while mining companies are evaluated in terms of individual mines. Similarly, consumer goods manufacturers are often evaluated in terms of their individual product lines or products. Some analysts carefully consider the effect on the entire company, industry, and economy as well as revenues and costs in forecasting the results for each reporting unit analyzed. [Also included in 1(b) and 1(c)] **[PREVITS, p. 15]**

A principal approach of many [equity sell-side] analysts for estimating a company's earnings per share involves the disaggregation of the company into as fine a set of reporting units as possible, followed by an earnings analysis and reaggregation. Segment related phrases appeared more than 20,000 times in the selected reports. This frequency was larger than any other grouping of related words and phrases except for income statement related phrases.

Analysts use a variety of phrases to refer to the operating units of corporations, including "lines", "areas", "businesses", "divisions", "units", "segments", and "subsidiaries". [Also included in 1(b) and 1(c)] **[PREVITS, p. 15]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on the types of information investors use to achieve their objectives, one investor was asked about the lack of disclosures about J.P. Morgan's "off-balance-sheet" earnings.

Participant I-12
We're starting to see some revenue data and some of the footnote information can be used to interpolate or extrapolate. It's a very difficult situation and that's a company that needs to show segment reporting; [names deleted], where you have banking businesses and securities trading businesses and transaction processing businesses. An analyst can make a lot of money going through those things because nobody knows what it is, so whatever you say, they'll assume you know what you're talking about. I do think there are useful tidbits in the footnotes. [Also included in 1(b)] **[TI 10/16, p. 29]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on the types of information investors use to achieve their objectives, two investors specifically mentioned how they use segment information to achieve their objectives.

Participant I-7
To the extent that the companies I follow provide us with some FAS 14 disclosures, I will incorporate in my model an attempt to tie the segmented earnings numbers to my annual and quartely model for the whole company. Increasingly, I have started for larger companies to make an attempt to project some kind of growth rate by business segments for the next 3 to 5 years. [Also included in 1(c)] **[TI 10/16, p. 49-50]**

Participant I-6
I start with all the details and do a "bottoms up" and that is easier with a basic industry company than a financial company. Even though there is a lack of data, the FAS 14 disclosures of some companies is fairly decent annually. I will look at the production by mine, by plant if I can get it, then I will build up the unit side of the equation and then multiply that by our expectation of the unit selling price to get a revenue-driven model. When we can, we break down the various cost components and forecast those. The production data feeds the income statement, feeds the cash flow statement, feeds the balance sheet, which feeds about 15 standard ratios that we use. You look for variations in those ratios each quarter or each year. That's the methodical part that takes very little of your time. That's where you start. [Also included in 1(c)] **[TI 10/16, p. 50]**

Participant I-6
I go into as much detail as I possibly can get and that usually is quarterly by segment: income statement, cash flow, I don't do that much on the balance sheet, definitely the equity section and maybe the debt section. Quarterly for the current year and the next year, and then annually for at least 5 years. [Also included in 1(c) and 11(e)] **[TI 10/16, p. 54]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information.

Participant I-13
I cover a minuscule industry called the precious metals mining business. I have been on a crusade for some time to get gold mining companies to adopt a standardized quarterly reporting format. That would save a great amount of time to analysts because they would know where to look to find the pieces of information they're interested in. It would be easy to impose a standardized format for an industry like mine because the companies are likely to be more uniform in the nature of the business that they're in. In that standardized format, the companies would give us cost by $ millions and revenue per product. In that way, you can build a quarterly income statement based on production data. [Also included in 3(b) and 11(c)] **[TI 12/9, p. 18]**

Committee/Staff/Observer
Question 6 relates to the format of segment disclosures. Based on the earlier discussions, we suspect that you don't care whether segment information is reported within the body of the financial statements, within the notes, or on a separate schedule. Are we right? **[TI 12/9, p. 24]**

Participant I-12
As long as it's there. **[TI 12/9, p. 24]**

Participant I-13
I disagree with that; I would like a standardized reporting format, as I alluded to earlier. **[TI 12/9, p. 24]**

Participant I-7
If the company in the annual report reports on a FASB 14 basis, the SEC should insist that they do so on the same basis in the quarterly reports. [Also included in 3(d)] **[TI 12/9, p. 24]**

Participant I-12
In terms of format, there are certain items that I would like to see. I would like to know how much of the costs, and in some cases revenues, are on allocated (or discretionary) basis as opposed to directly attributable to the business, because those allocations can really make a massive difference. As long as I know what the number is, then I can determine whether or not it is appropriate. [Also included in 3(c)] **[TI 12/9, p. 25]**

Committee/Staff/Observer
Let me get more specific. We have some bullets on page 8 on instances when you would prefer that a specific format be mandated for certain segment information. For example, discontinued operations? **[TI 12/9, p. 25]**

Participant I-6
If they are truly discontinued operations, then they should be reported separately and the prior years should be adjusted to reflect that fact. **[TI 12/9, p. 25]**

Committee/Staff/Observer
How about multi-column consolidating financial statements; should they be required? **[TI 12/9, p. 25]**

Participant I-7
I'm going to distribute two sheets; the top sheet is the [one company] consolidation and deconsolidation, the second sheet is [another company]. Those are two examples of deconsolidating statements; I think this information is very helpful. **[TI 12/9, p. 25]**

Participant I-11
The answer is yes; the answer is why the FASB didn't think of that before they enacted FASB 94. **[TI 12/9, p. 25]**

Committee/Staff/Observer
How about the third bullet? If consolidating financial statements are required, should they include consolidating cash flow statements? And should the direct or indirect method be required or should the format be optional? [Also included in 5(c)] **[TI 12/9, p. 26]**

Participant I-6
Yes, they should be required. I think the cash flow statement is extremely important. [Also included in 5(c)] **[TI 12/9, p. 26]**

Committee/Staff/Observer
We don't seem to have a strong feeling one way or the other on the direct versus indirect method question. [Also included in 5(c)] **[TI 12/9, p. 26]**

Committee/Staff/Observer
I'm surprised there's not more reaction for a change to the direct method of cash flow reporting because I have heard that before. [Also included in 5(c)] **[TI 12/9, p. 26]**

Participant I-12
I'm still waiting for someone to come up with a decent definition of cash flow in a financial company. [Also included in 5(c)] **[TI 12/9, p. 26]**

Participant I-12
There are a few companies that change how they look at segments about every 2 years. So you get one year's worth of comparable, then the next year they change it. To try to get a 5

year history is extremely difficult. The company [name deleted] says that they do this because they have reorganized the fundamental way they do the business. It would be nice to have some disclosure to assess how much of the revenues, for example, have been altered as a result of the change. [Also included in 2(c)] **[TI 12/9, p. 29]**

Participant I-4
[Participant I-12] would [name deleted] recast old figures when they do that? [Also included in 2(c)] **[TI 12/9, p. 29]**

Participant I-12
They will recast for one year, so you get a year over year comparison. [Also included in 2(c)] **[TI 12/9, p. 29]**

Participant I-6
I would like to see a 5 or 10 year requirement for segment disclosure. My companies do the same thing, they're constantly reshuffling and reorganizing. I'm not opposed to that but they should give us a 5 year history or give us more detail beyong 3 or 4 major categories of segments, which means that the detail within it is more meaningful. [Also included in 2(c)] **[TI 12/9, p. 29]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display. At the end of the discussion, participants were asked if they had any enthusiasm for display issues.

Participant I-12
The notion of segment reporting is a big display issue, but the substance should drive the display. The display issues should fall from the resolution of the substantive issues. [Also included in 5(d)] **[TI 1/13, p. 41]**

Participant I-8
I have great enthusiasm for that fixed, semi-fixed, and variable, just as much as for segment reporting. [Also included in 5(a)] **[TI 1/13, p. 41]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of disaggregated information.

Participant C-6
We're constantly running into managements that are saying they don't want to disclose segment information for competitive reasons. So we get a lot out of them when they come in and have a one on one discussion with us for an hour. We get more out of that than we'll get out of a financial statement. [Also included in 3(a)] **[TC 12/8, p. 19]**

Committee/Staff/Observer
Question 7, FASB 14 requires segment disclosure for public companies. Yet we think we hear, and I think that's consistent with words I've heard at this table today, that there may be an interest in non-public company segment reporting. The question is is that true, and if so, when? That is always? Never? Somewhere in between? When? **[TC 12/8, p. 33]**

Participant C-10
We have public companies in the high yield market. We lots of times have companies that are stockpiling their information, 10-Qs and 10-Ks because they don't have 300 security holders, and they can file I think it's a form 15 with the SEC and stockpile them. Yet to my mind that's a public company. And yet we have just as great a need for that information there as any of the others. **[TC 12/8, p. 33-34]**

Committee/Staff/Observer
Always you need it? **[TC 12/8, p. 34]**

Participant C-10
Yes. 10-Ks and 10-Qs is the main flow of information that we use for every financial debt instrument we have. **[TC 12/8, p. 34]**

Participant C-1
The thing is the smaller the company, the less you need it, because the less likely they are in separate, different segments. A lot of companies, as [participant C-10] points out, that we consider public consider themselves to be non-public. And it should be consistent accounting across all the entities. [Also included in 2(c)] **[TC 12/8, p. 34]**

Participant C-6
I deal almost strictly with private companies or non-public companies, and of course I would advocate more disclosure as far as non-public companies. However, in thinking about this before the meeting, it's quite difficult to delineate at what size you start to institute these requirements. So it's an area where I think we should try to move towards getting some more information out there to credit grantors, but it's just difficult to say at what size you start to delineate. **[TC 12/8, p. 34]**

Committee/Staff/Observer
[Participant C-6], what do you mean when you say it's more difficult to get the information or to ask for the information? **[TC 12/8, p. 34]**

Participant C-6
You can ask for as much information as you want, and I get most of my information through discussions with management. But I'm on a much smaller scale than most of the other people here. So I'm able to go and meet one on one with the company owner, and get information that I want to get. But for having them to start to report information, that becomes a difficult area. **[TC 12/8, p. 34-35]**

Participant C-15
It just seems to me that a lot of this is driven by the SEC and their disclosure requirements to protect investors. And almost by definition there aren't investors in private companies. There are creditors, and I think it gets pretty expensive to compile all this information. It would seem to me that discussions with companies would suffice rather than have requirements of public companies be imposed on private companies. **[TC 12/8, p. 35]**

Committee/Staff/Observer
Can I follow up to that and ask [participant C-15] and [participant C-14]: when you rate a private company for credit purposes, do you demand virtually the same type of information that you would get from a public company? **[TC 12/8, p. 35]**

Participant C-15
Yes. But I can count on one hand the number of private companies that we rate, and they would be for the most part several billion dollars in assets. So I think they may be privately held, but they think and act like public companies, if you will. **[TC 12/8, p. 35]**

Participant C-12
I feel very strongly about the need for segment information. And for a large company to say it's one segment I think is misleading publicly. **[TC 12/8, p. 35]**

Participant C-5
I think the establishment of a standard is what's important. We can in bank credit demand disaggregated disclosure of our borrowers assuming the standard is out there. We don't need to force this on non-borrowing private companies. Therefore there is a point at which the public markets, which don't have the ability to do negotiated credit structures, need to have a requirement. **[TC 12/8, p. 35-36]**

Committee/Staff/Observer
[Participant C-5], there is a standard on segment reporting which is out there, and my question is if you're a private company can a credit grantor and does a credit grantor demand that that company follow that standard, although the standard says it doesn't have to? **[TC 12/8, p. 36]**

Participant C-5
We typically are legal entity reporting, and we do demand that of our borrowers. We look for legal entity statements at the borrowing/operating company level. We make that demand despite the fact that it's not required for SEC reporting. We get the kind of information we need. I would put that lower on the scale as far as requirements. As I said, the recurring nature and the projecting core earnings is really the driver for us. But if it is out there, the idea of imposing it on the small borrower or the private sector borrowing is not something that I see as necessary. [Also included in 1(d)] **[TC 12/8, p. 36]**

Participant C-1
That's the difference between publicly disclosed information and non-public inside information. And I think that's one of the problems; you have the ability to get non-public inside information, and we don't have that ability. And we don't want it. [Also included in 1(d)] **[TC 12/8, p. 36]**

Committee/Staff/Observer
Why don't you want it? [Also included in 1(d)] **[TC 12/8, p. 36]**

Participant C-1
The issue that we have is the ability to be active in the markets in the trade. And once we receive non-public inside information, we're frozen. And it's a very fine line that we have to walk as analysts or portfolio managers between non-public inside information and public information. And legal entity borrowing, that's just something we would never see. [Also included in 1(d)] **[TC 12/8, p. 36-37]**

Committee/Staff/Observer
One of the things we're interested in as a committee is information that private companies that don't have to be worried about inside information find essential in order to make their lending decision. And then drawing from that a rebuttable presumption that that information would be useful and perhaps necessary for all entities. So we're very interested in information that lenders to private companies deem very important to see if perhaps that shouldn't be a part of a set of public information. **[TC 12/8, p. 37]**

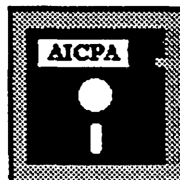
Participant C-8
The bonds that we issue for our clients are always at the operating company level. So we almost always will require legal entity financial information. But I don't know that we would want to impose that on every private company to have to put it in, because many companies have thousands, hundreds of legal entities that really aren't active, and they only activate them when there is a reason to activate them. **[TC 12/8, p. 37]**

Analysts were able to identify many areas in which they believed expanded disclosures would be useful, but most of those had little or no relation to fair value information. The disclosures they were most interested in were: [Also included in 3(c), 5(b), 10(c), 13, and 17(f)] **[KPMG BANK STUDY, p. 38]**

- Detailed qualitative and quantitative descriptions of asset concentration, e.g., by geographic location, borrower's industry, collateral types [Also included in 13] **[KPMG BANK STUDY, p. 38]**

4. Value Information

Data Base Code		Data Base Code	
SRI	□	S&P	□
RMA90	■	BETRIOU	■
RMA92	□	R.G. ASSOCIATES	□
FASOversight	■	HARRIS	■
AIMR/CIC90	□	TI 10/16	□
AIMR/CIC91	□	PMQI 10/16	□
AIMR/CIC92	□	TI 12/9	■
AIMR/FAF91	□	PMQI 12/9 and 1/13	■
AIMR FIN SER INDUSTRY	■	TI 1/13	■
AIMR/FAPC92	■	TI 3/17	■
LYNCH	□	PMQI 3/17	■
KPMG BANK STUDY	■	TC 12/8	■
BEAR STEARNS	□	PMQC 12/8	□
GOLDMAN	■	TC 2/2	■
FREEDMAN	□	PMQC 2/2	■
PREVITS	■	TC 3/11	■
HILL KNOWLTON	■	PMQC 3/11	■
TOWERS PERRIN	□	TMKT 4/7	■



4. Value Information

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to . . . the needs of users. **[FASOversight, p. 1]**

- Disclosure of the impact of changing interest rates on expected future cash flows and asset values would be meaningful. **[FASOversight, p. 2]**

The APC [Accounting Policy Committee] has considered and expresses below its opinions on a number of specific issues affecting financial accounting standards and financial reports. The APC believes that the following items should be included in the single body of accounting concepts, standards, principles and methods: **[RMA90, p. 5]**

- The fundamental basis of accounting is measurement based on the exchange prices of actual transactions. Thus, assets should initially be recognized at the amount of their historic cost and liabilities at the amount of cash or the fair market value of other assets received in exchange for them. The cost of long-lived assets should be matched periodically to the benefits (revenues) received from their use via systematic amortization procedures. Assets held for sale should continue to be measured at cost until an event permitting realization has occurred. An "event" means a transaction or similar event that establishes with a high degree of certainty both an increase in value of an asset and the enterprise's ability to obtain cash in the amount of that value. **[RMA90, p. 5]**

  By the same token, differences between the initial amount of a long-term liability and the aggregate contractual amounts to repay it in the future establish an historic rate of interest. That interest rate should be used to record interest accruals on the debt regardless of changes in "market" rates. **[RMA90, p. 5]**

- Current market value information is highly esteemed by and frequently requested of borrowers by lenders. However, with the exception of a few well-organized auction markets, its measurement is less precise and more subject to personal bias than is acceptable for financial statements. Until such time as the reliability of current value measurements can be demonstrated, general purpose financial statements should continue to

be based on historic cost, and reports that use current value should be presented as supplementary information only. **[RMA90, p. 5]**

- Financial assets and liabilities represent agreements to convey specific amounts of cash from borrowers to lenders at specific future dates. Interest represents the difference between the amount borrowed and the aggregate amount to be repaid. The rate of interest implicit in a financial obligation is established at the inception of the agreement and is called the historic rate. Interest revenue (expense) should be reported periodically on the income statement by applying the historic rate to the unpaid balance of the obligation at the beginning of the period. Interest accrued in excess of a period's payments should be added to the debt; payments in excess of interest accruals should be deducted. [Also included in 5(b)] **[RMA90, p. 9]**

  In cases where the initial borrowing involves consideration other than cash, the historic rate of interest should be estimated by reference to rates of interest on debt instruments of similar duration and risk. In all cases, there should be disclosure of information that allows financial statement users to know or calculate the contractual amounts of cash payments required by the obligation, both periodic ("coupon") and final ("face"). [Also included in 5(b)] **[RMA90, p. 9]**

[Fifty-eight] percent of the professional [investors] sample said that annual reports all too often fail to present information that reveals the underlying values of a company. **[HILL KNOWLTON, p. 12]**

Long term productive asset values on the balance sheet are nearly always evaluated at cost [by equity sell-side analysts]. The effect of inflation on such assets rarely is explicitly considered. However, for some companies, a supplemental analysis of assets' market value is conducted. This is undertaken for firms analysts consider to be poorly understood by other analysts and investors, and particularly where latent significant off-balance-sheet or hidden assets may exist. [Also included in 1(b), 1(c), and 5(b)] **[PREVITS, p. 17]**

[A]nalysts asserted that a cable television company had substantial off-balance-sheet assets in the form of residual payments to be received in the future. They calculated the value of the company using several methods, one being the present value of the anticipated cash flows from these residuals. One analyst stated that "balance sheet recognition of . . . hidden asset values . . . will occur in future years". Other examples include inventory and reserve valuations of extractive industry companies. For instance, in gold mining companies, a market value appraisal is included of the reserve values by ore type. [Also included in 1(b), 1(c), 5(b), and 5(c)] **[PREVITS, p. 17]**

[Equity sell-side] analysts distinguish between valuations based upon the company's continued existence in its present form: so called fundamental value, and valuations based upon acquisition or breakup of the company. Analysts use several approaches to valuing companies based on fundamentals, most typically in terms of the present value of the company's cash flows, its earnings, or balance sheet valuations. In this approach analysts also distinguish between a company's "Public market value" and "private market value". For example, one analysts measures the fundamental value of a company in terms of:

1) Private market value
2) Price/revenues
3) Price/book value
4) Price/long-term earnings
5) Growth-driven valuation composite
6) Contrarian composite [e.g. Bearish Sentiment Indicators]
7) Earnings momentum composite
8) Technical ranking
9) Beta

[Also included in 1(b) and 1(c)] **[PREVITS, p. 19]**

Another analyst valued companies in terms of revenue, cash flow multiples, and net income. And yet another analyst valued a cable TV company with purported off-balance-sheet assets on three basis:

1) present value of cash flows,
2) appraised value of assets and
3) the company's liquidation value.

[Also included in 1(a), 1(b) and 1(c)] **[PREVITS, p. 19]**

Another analyst evaluated the same cable TV company by analyzing each of the many limited partnerships with which the company was related in order to estimate the long-range cash flows of each to the company. [Also included in 1(a), 1(b), and 1(c)] **[PREVITS, p. 19]**

Analysts label valuations of a company based upon it acquisition or breakup as it "buyout value", "breakup value", "takeover value", "theoretical breakup value", and so forth. Examples of computed break up value include the following:

1) Estimated breakup value = asset values at market price less liabilities.
2) Adjusted breakup value takes the above and adds other "likely" assets.
3) Possible breakup value adds other "possible" assets to all of the above.

[Also included in 1(a), 1(b), and 1(c)] **[PREVITS, p. 19]**

The second major issue pertaining to financial services is whether "mark-to-market" accounting is the remedy for the deficiencies of historic cost as applied to financial instruments. Some analysts support it wholeheartedly and believe that it should supplant historic cost on the financial statements. Others have reservations about or are opposed to

market value accounting. None is opposed to disclosure of market values and most believe that it is vital. Some urge caution to avoid disclosures that are incomplete or that imply that market value disclosure can easily be substituted for the historic valuations that appear on financial statements now. In sum, analysts are agreed that information about market values is important, but differ as to the degree of importance and the extent to which they should be incorporated in financial reports. This topic is discussed at greater length later in this report. [Also included in 19] **[AIMR/FAPC92, p. 19]**

[Context] The following brief summary of the topic "'Mark-to-Market' Accounting: Value versus Valuation," is from the "Executive Summary" of the report of the AIMR's Financial Accounting Policy Committee (FAPC):

> Any imminent change to "mark-to-market" accounting is not welcomed by the majority of financial analysts. They would not be happy to see historic costs removed from the financial statements. They are not convinced that there would be an increase in relevance sufficient to offset the reduction in reliability of the new data. Others disagree and are anxious to see and use market values in their work. In fact, the spectrum of opinion among analysts on the subject is so broad that it cannot be represented succinctly. Furthermore, it varies depending on the extent to which mark-to-market accounting would apply. Some would approve of it for financial instruments or some financial instruments, but not for tangible or other intangible assets. There is agreement, at least within the FAPC, that marketable equity securities should be reported at market and that the disclosures of market values of financial instruments required by *Statement of Financial Accounting Standards 107* will provide potentially useful information without any corresponding loss of other data. **[AIMR/FAPC92, p. vii and viii]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

> Securities and Exchange Commission Chairman Richard Breeden has been quoted as saying that financial reports should begin with the phrase "Once upon a time..." His statement certainly was made with pejorative intent, given his many public statements in favor of recording financial assets at their market value, so-called "mark-to-market" accounting. In addition to the public advocacy of mark-to-market accounting by Chairman Breeden, there have been other initiatives in that direction both in the United States and abroad. The Financial Accounting Standards Board, in its financial instruments project, has issued one statement [FAS 107] that requires disclosure of the market value of all financial instruments and it also has suggested market values as potentially appropriate measures in its Discussion Memorandum, "Recognition and Measurement of Financial Instruments." Members of the Accounting Standards Board in the United Kingdom also have expressed strong support for using market values in financial reports. **[AIMR/FAPC92, p. 24]**

AIMR members have different views on market values. All favor disclosure of market values, at least for financial instruments. None believes that disclosure alone could be detrimental to their interests, and all but a few believe that it would be beneficial. Most are opposed to replacing historic cost with market values, but a significant minority would favor such a move. Most would oppose extending mark-to-market accounting from financial assets to real assets, although a small number would not. All agree that if mark-to-market accounting were to be mandated, it should be applied with equanimity to both the left-hand side and the right-hand side of the balance sheet. All agree that it is only assets and liabilities that should be marked to market; determination of the market values of entire firms is the business of financial analysis, not financial reporting. Mark-to-market accounting has many ramifications, discussed in detail below, which have differential persuasive power on individual analysts. **[AIMR/FAPC92, p. 24]**

Knowing What Market Value Is

It is axiomatic that it is better to know what something is worth now than what it was worth at some moment in the past. However, that is easier said than done. Much has been made of the fact that securities firms and mutual funds mark their balance sheets to market daily. The question is asked why banks and other financial institutions cannot do the same. The answer is that it can be done, but with conceptual and practical difficulties that do not exist for security firms and mutual funds. **[AIMR/FAPC92, p. 24]**

Balance sheets that are marked to market now are done so on a daily basis. They are never out of date, because they are replaced by a new balance sheet every single business day. Other enterprises issue financial statements less frequently, quarterly and annually. Furthermore, it takes some time after the balance sheet date to prepare and disseminate it. By the time the balance sheet reaches the analyst it already is out of date. Historic cost itself is in reality historic market value, the amount of a past transaction engaged in by the firm. Some argue that if we are to be presented with market values that are bound to be historic by the time they arrive, we are better off with older but transaction-based historic cost. **[AIMR/FAPC92, p. 24]**

The counter-arguments to that line of reasoning are two in number. First, many historic costs are seriously out of date. They may have little relation to the current market value of assets, whereas the only-slightly-out-of-date balance sheet market values still will have a good amount of relevance. Second, market value data are comparable. If all enterprises mark their balance sheets to market on the same date, they are all "out-of-date" by the same interval. Historic cost data are never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms, or even within a single firm. **[AIMR/FAPC92, p. 24-25]**

There is no financial analyst who would not want to know the market value of individual assets and liabilities. However, there are many who believe that those values are essentially unknowable. **[AIMR/FAPC92, p. 25]**

Applicability Limited by Measurement Problems

When the term "market value" is used, one is inclined to conjure up a mental picture of the busy trading floors of the New York Stock Exchange or the Chicago Board of Trade, frenzied with the activity of bringing together the effects on supply and demand of innumerable well-informed traders. A variety of equity securities, debt instruments, and commodities have their values continually being revised by frequent trades in well-functioning auction markets. Many other assets, including a myriad of financial instruments, do not trade frequently, and when they do trade the amounts exchanged can deviate considerably over short periods of time. Supply and demand for a large number of financial assets is so thin as to defy determining their market values at any moment with a great deal of precision. **[AIMR/FAPC92, p. 25]**

An alternate approach is to determine the market rate of interest at which to discount a given stream of cash flows expected to emanate from a particular financial instrument or portfolio of similar instruments. This might work with financial instruments that are securities, such as bonds, where the rates at which more popular issues trade could be applied to less frequently traded issues of the same credit quality. However, even there one could infer that the rate on the marketable issue probably would be lower than that of a bond which is harder to liquidate. We also encounter the problem of determining the market rate of interest for financial instruments that do not trade, eg. portfolios of consumer or business loans. How could we assure comparability among a vast number of country banks choosing to measure with the same interest rate, even though they may have different costs of funds and local or regional variations in business conditions and credit risk? **[AIMR/FAPC92, p. 25]**

Although our experience in the securities industry indicates to us that mark-to-market measures lack a good amount of reliability, one exception is marketable equity securities. As they are defined by Statementf Financial Accounting Standards No. 12, "Accounting for Certain Martable Securities," they have market values that are relatively easily determined by frequent trades in markets of sizable breadt h and depth. All but one member of AIMR's Accounting Policy Committee agree that those securities should be reported at market value. In fact, the FAPC recommends that market value replace the lower-of-cost-or-market method currently mandated for those securities. The FAPC's view is based also on the unique characteristic of equity securities that they provide no contractually-specified future cash payments[5]. Therefore, in their case, expected or hoped-for changes in market value are much if not all of the reason for investing in them. [Also included in 8(d)] **[AIMR/FAPC92, p. 25-26]**

Debt securities present a different situation. Many investors in these securities have little interest in the day-to-day changes in their quoted prices. They hold such securities primarily

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[5] This recommendation also applies to preferred stocks, even though they have a specified dividend amount or rate. That dividend is a ceiling, not a floor, on the amount to be paid; and the preferred dividend itself constitutes a preference not a claim. The FAPC is on record, in previous comments to the FASB, as advocating that a preferred stock which carries a mandatory payment requirement be recorded and reported as a liability.

in anticipation of collecting their future cash proceeds. The vast majority of debt security holders are financial institutions that seek to match streams of cash inflows from investments to their obligations payable in cash outflows. A basic principle of managing a financial intermediary is to minimize interest rate risk by linking financial asset investments to financial instrument liabilities. The process is best characterized as being one step short of hedging. Until methods are available to determine with reliability the market values of all the related financial liabilities we cannot support a unilateral marking to market of the assets alone. **[AIMR/FAPC92, p. 26]**

We are very aware of the fact that some institutions, in particular certain failed savings associations, have engaged in gains trading ("cherry-picking" to some) in their bond investment portfolio. That leaves a portfolio primarily constituted of bonds whose market price is less than cost; the portfolio is said to be "under water." This objectionable practice would be eliminated by mark-to-market accounting under which gains and losses would be recognized as they occur, rather than as the effect of an exchange. Furthermore, whether investments in bonds are accounted for at cost, at market, or otherwise, the reported amounts of gains and losses should be separated from other revenues and expenses on the income statement so that financial analysts and others can both detect and evaluate them. If that procedure were to be followed, then under current GAAP gains trading should be evident to an astute analyst who looks closely both at the institution's sources of earnings and at its disclosures of the market values of portfolios being carried at cost. We also believe that it is unjust to mandate a costly change in accounting for well-managed institutions to atone for the misconduct of others. **[AIMR/FAPC92, p. 26]**

<u>How to Implement Mark-to-Market Accounting</u>
What would be the scope of mark-to-market accounting if it should be employed? Will it apply to all assets or only some? Both assets and liabilities? All assets and some liabilities? Will it apply to all industries or only to some? Will it apply differently to different types of companies? These are the several broad questions that at least have to be considered before we plunge into the unknown. **[AIMR/FAPC92, p. 26]**

We start by considering a recent and current problem: how to value the bond portfolio(s) of financial intermediaries. At the urging of the SEC, the problem was deliberated at length by the Accounting Standards Executive Committee (AcSEC) of the AICPA, which issued several exposure drafts of position papers. When those efforts proved unsuccessful, the problem was passed on to the FASB. Many observers note that marking to market only the bond investment portfolio introduces to reported earnings a volatility that does not really exist because it is in effect canceled by unrecognized changes in counterpart liabilities. However, counterparts cannot be identified that specifically relate to a bond portfolio. Thus, one is led to conclude that mark-to-market could only work if it were applied to all assets and liabilities. In financial institutions, that entails all the measurement difficulties discussed above. **[AIMR/FAPC92, p. 26-27]**

It also forces consideration of the valuation of core deposits. Theoretically, there is no way in which a liability that must be paid at face amount on demand should have a market different from its nominal amount. But sometimes it can. This has been borne out by prices paid to acquire financial intermediaries. Even more dramatic evidence has come via recent "sales" of core deposits alone. The "sale" involves the acquiring institution accepting core deposit liabilities of a certain stated amount in exchange for receiving assets of a lesser amount. The valuation of core deposits is extremely controversial and it appears unlikely that recognition of their market value would be allowed, either directly or through recognition of a core deposit intangible asset. Even if recognition were permitted, how would the value of core deposits that are not traded be measured? **[AIMR/FAPC92, p. 27]**

For non-financial enterprises, how should mark-to-market accounting be applied, or should it? If financial services enterprises are required to mark their financial instruments to market, should not all firms that hold or issue financial instruments also be required to record them at market value? For some such enterprises that hold large and stable interests in other enterprises, doing so would introduce a volatility into reported earnings that seems unrelated to the economic accomplishment of the period. However, most assets of such firms are non-financial, either tangible such as inventory and plant, or intangibles of various sorts. Marking these to market would require solutions to different measurement problems, the pursuit of which unfortunately ceased when the FASB issued *FAS 89*[6] The concept of measuring the current cost (or some other current market value) of tangible assets is relatively straightforward, but its application may encounter practical difficulties and often produces less-than-precise measurements. Answers with respect to intangible assets are not so obvious and we devote a separate section of this report below to their consideration. **[AIMR/FAPC92, p. 27]**

Effect of Market Value Changes on Trend Analysis

Many financial analysts oppose mark-to-market accounting because of its potential effects on their analysis of trends. Much current analysis of financial intermediaries focuses on changes in balance sheet items stated at historic cost. Trend analysis, in particular, requires comparable numbers period by period. Historic costs allow analysts to assess changes in a financial intermediary's financial position without having first to remove the confounding effects on that position of exogenous economic events. For example, analytic disaggregation of a loan portfolio by geographic area, purpose of loan (commercial real estate, consumer credit, etc.), and otherwise is essential to understanding the risks and exposures of a financial institution. Many analysts seek data that reveal the changes in the intermediary's portfolio resulting from transactions, excluding the effect of changes imposed by the market. In addition, they wish to compare historic yields on investments in securities and other financial instruments with the institution's overall and regional cost of funds. Those analysts feel that

[6] This standard removed the requirement, under FAS33, for disclosure of supplementary information on changing prices. Although *FAS 89* encourages such disclosures, they have rarely been seen in American financial reporting since the requirement was removed.

important data would be irretrievably lost if historic costs were supplanted in the financial statements themselves by mark-to-market accounting. **[AIMR/FAPC92, p. 27-28]**

Effect of Market Value Changes on Income

No matter how well mark-to-market accounting could be implemented and applied judiciously to matched assets and liabilities, it still would increase significantly the volatility of reported earnings. Some argue that the volatility exists and that a primary benefit of mark-to-market accounting is that real volatility would be revealed. Even if we concede that point, the question becomes one of how business enterprises and the capital markets are to deal with it. [Also included in 5(a)] **[AIMR/FAPC92, p. 28]**

As financial reporting is practiced today, financial managers have much discretion over the recognition of changes in value by astute timing of exchange transactions and by the adoption of artful allocation procedures. Mark-to-market accounting would take away much of that discretion. Even where the relative influence of market value changes is small overall, at the margin it has the propensity to make earnings exceedingly unpredictable, a disconcerting fact for enterprises trying to minimize their capital costs by reporting smooth and growing earnings. [Also included in 5(a)] **[AIMR/FAPC92, p. 28]**

Some analysts are quite willing to accept the increases in reported income volatility that would be produced under mark-to-market accounting. Many of them even would welcome it. They feel that the effects on a particular enterprise of general economic conditions and financial market movements are relevant and to some degree vital to their assessments of its economic status and progress over time. They may not yet be ready to do away with historic cost entirely, but they look forward to the opportunity of integrating FAS 107 data into their evaluations and forecasts as soon as they become generally available. [Also included in 5(a)] **[AIMR/FAPC92, p. 28]**

One method for dealing with changing market values and their effect on income would be for the FASB to generate accounting standards that put into practice the concept of comprehensive income that appears in Concepts Statement No. 6. As defined in Paragraphs 73-77 of that statement, comprehensive income would encompass all changes in owners' equity exclusive of transactions with owners themselves. It would also be disaggregated into a variety of basic components and intermediate components. Thus the effect of exogenous events such as market value changes would be separated from the effect of endogenous productive activities. If market value changes were reported separately and clearly, their effect isolated, then their unpredictability would assume a lesser importance as it was assessed separately from productive activities. [Also included in 5(a)] **[AIMR/FAPC92, p. 28]**

Prognosis for Mark-to-Market Accounting

A few financial analysts and investment managers are unequivocally opposed to and a few unalterably in favor of mark-to-market accounting. But most have adopted a wait-and-see attitude. It is difficult to forsake historic cost when it is uncertain that its replacement will

accomplish what its advocates promise. FAS 107, which takes effect for fiscal periods ending after December 15, 1992, requires disclosure of the market value of all financial instrument assets but only some of the related liabilities. We anticipate that many of the problems set forth in the preceding discussion will be encountered in its application. We welcome the opportunity to deal with them in a realistic setting without having to make a total commitment and changeover to mark-to-market accounting. We also expect that at least some of the experience gained from applying FAS 107 to financial instruments may be transferable later to nonfinancial assets and liabilities. **[AIMR/FAPC92, p. 28-29]**

Finally, we note that mark-to-market accounting is intended to apply to individual assets and/or liabilities, either singly or in portfolios of homogeneous components. Despite our overall opposition to its imminent adoption, we consider it to be appropriately within the domain of the accounting function. On the other hand, when it comes to the valuation of business enterprises, either singly, in groups, or by components, we rightfully regard that as the province of financial analysis and a matter beyond the scope of financial reporting. [Also included in 1(c)] **[AIMR/FAPC92, p. 29]**

[Context] The AIMR report's introduction to the section entitled "Summary of Important Positions and Guide to Future Actions" begins and ends as follows:

Much of this report relates to the present state of the art and implications for future developments in financial reporting. Righfully, so do most of the positions stated in this section . . . [T]hey all build on positions taken by AIMR in the past . . . [Also included in 1(b), 1(d), 3(d), 5(a), 8(c), 11(a), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 59]**

We expect the positions set forth below to build on the precedents of the past. That does not prevent them from breaking new ground, but they do not introduce significant inconsistencies with previous AIMR positions. To the extent that they do establish new stances those are largely the result of the changing world that we describe earlier in this report. [Also included in 1(b), 1(d), 3(d), 5(a), 8(c), 11(a), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 60]**

Those two paragraphs introduce the following summary of a position taken by the Committee.

<u>The Role of Current Values in Financial Reports</u>
A great controversy has arisen recently over "mark-to-market" accounting. Feelings are strong both in favor of it and against it with a spectrum of opinion in between. Financial analysts also have diverse views, even though they are not as extreme as others may be. No financial analyst is opposed to the disclosure of current values, in fact most would welcome it. On the other hand, no analyst is at this time prepared to abandon totally the historic-cost-based but eclectic system of valuation used in accounting today. In fact, most financial analysts are

going to require much persuasion before they will be willing to accept expansion of the role of current value in financial statements themselves. [Also included in 1(d)] **[AIMR/FAPC92, p. 61]**

Much of the unwillingness of financial analysts to accept immediately a greater use of market values in financial statements stems from a perceived need for utmost reliability in the numbers provided to them. They feel that even though historic costs are subject to certain manipulation, the situation could be worse with respect to numbers that are not verifiable by reference to a transaction in which the enterprise participated. Some analysts are concerned also about partial measures. They feel, for example, that marking the securities portfolio and (perhaps) other assets of a bank to market is misleading if that institution's liabilities are not revalued also. Their concern is the one expressed in the preceding section, that the financial report on the business will not reflect the manner in which it is managed. [Also included in 1(d)] **[AIMR/FAPC92, p. 61-62]**

The process of learning to understand and use new and unfamiliar financial information is longer and more arduous than anyone might expect. In FAS 33, we were provided with information that, although imprecise, was a godsend to those financial analysts who understood it and were able to use it in their work. Unfortunately, the FASB's five-year experiment came to an end before more than a modicum of financial analysts were able to take the necessary time from the press of their day-to-day duties to study and grasp the significance of inflation-adjusted data. That experience also was undermined by the incessant claims of individual business enterprises that the disclosures required by FAS 33 were worthless, and by the rapid decline in the rate of inflation during that five-year period. [Also included in 1(d)] **[AIMR/FAPC92, p. 62]**

Our position is that we would like current value reporting to be given a chance. We need to be able to assess the extent to which volatility really exists even though the financial statements themselves may, as a political matter, need to be shielded from it. As long as current values are not seen, financial analysts cannot use them. However, the vehicle of disclosure should be used so as to offer financial analysts the opportunity to use current values. They should not be coerced into it by a sudden and unilateral removal from financial statements of the historic costs and other amounts which are familiar and useful to so many financial analysts. [Also included in 1(d)] **[AIMR/FAPC92, p. 62]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of measurement uncertainties. During the discussion, one investor made reference to value information.

Participant I-9
I don't think you can ask the companies to do this. This prejudices their negotiating of settlement of claims. A company can't put a number in there that they would be happy to settle for without costing the shareholders value over time because that's a blank check. The two areas in which I find information would be most helpful on are real estate (fair value that could be realized in an orderly liquidation over time) and the health care benefits assumptions. On the latter, companies like [names deleted] are not using numbers that are relevant to past history because if they did they would be insolvent. We want the accounting profession to at least put us on notice that the inflation rate in health care that they're using doesn't bear any relationship to what's going on over the last 20 years. We can't do that ourselves. [Also included in 9] **[TI 12/9, p. 65-66]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of value information.

Committee/Staff/Observer
Although not plentiful, the Special Committee has located several sources that discuss users' interest in fair value information. Based on the materials that we have reviewed to date, we understand that investors are interested in fair value information if it is provided in addition to the historical-cost-based-measurements currently used in financial statements, but not in lieu of that information. **[TI 1/13, p. 2]**

Our question is: Do you agree with our understanding? If so, why do you want information based on both kinds of measurements? That is, what does one kind of measurement tell you that the other kind does not? **[TI 1/13, p. 2]**

Participant I-12
I cover financial companies and this is a very important issue. I think the current market value disclosures for publicly traded instruments makes perfect sense to me and I'm happy with the current disclosures. But if you're going to a full market value accounting model, you're in essence looking at liquidation value accounting and that is in conflict with the going concern principle. So I don't really find much value-added with the direction that accounting is moving on this issue; in fact, I think it could provide disinformation. Another troubling issue is where do you make the adjustment between cost and fair value; in the income statement (introducing a lot of volatility in earnings) or in equity (running the risk that a company might be closed down simply because of the mark-to-market)? In some circumstances, the latter scenario might be appropriate, but we all lived over the past 10-15 years through instances where that might not be appropriate. **[TI 1/13, p. 2]**

Participant I-15
I agree with [participant I-12] on many things, but if you look, for example, at the bankruptcy of [names deleted], if the assets had been marked to market, you would have realized that the

company wasn't a going concern, because the assets were obsolete and vastly overstated on the books. I follow the airline industry, and you haven't had a transaction on a used piece of equipment in three years; it's an example of where fair value for assets would be very helpful and it should be disclosed. **[TI 1/13, p. 3]**

Participant I-7
In terms of manufacturing companies, I find fair value for the most part of relatively limited interest. However, to the extent that some of my companies have moved off to the financial service arena, and the ground rules have been changed on those businesses, then I absolutely would want to have fair value information in at least a notational form for financial assets. **[TI 1/13, p. 3]**

Committee/Staff/Observer
[Participant I-12] for question 1(a), please try to get the volatility aspect out of the equation; we will get to that. **[TI 1/13, p. 3]**

Participant I-11
I'm not sure you can get away from that because I think it addresses a broader issue. I think, when talking about fair value, you have to distinguish between financial assets and nonfinancial assets, particularly between highly-liquid, publicly-traded assets, and others. On the sell-side, we have been living in a mark-to-market world all our life, so that's no strange animal to us. But I don't think it makes a lot of sense for nonfinancial assets because who determines the market? What is fair value? As anybody who has been involved with appraisals or merger negotiations knows, there can be wide honest differences of opinions about what constitutes fair value. **[TI 1/13, p. 3]**

As I said, there is a broader issue here. I use historical financial statements as one of the benchmarks that is helpful to me in making forecasts of future performance. What I need is to be confident that the benchmark I'm using stays the same, and I think that historical financial statements provide that sort of stable reference point. I'm not sure that it is the accountant's job to determine that [name deleted's] assets were worth less than historical cost; I think that's the analyst's job. What I get from the historical statements is a determination of how management allocated assets and the subsequent outcome of those decisions; I think that gives me some guidance on the future. But if every time I open a set of financial statements of a company and it's different than the one I looked at the previous quarter or previous year, I'm at sea. So let's get away from arbitrary adjustments to financial statements to solve some imputed or imagined or perhaps real abuse we think we see, because it's probably going to create new ones. [Also included in 1(c)] **[TI 1/13, p. 3-4]**

Committee/Staff/Observer
With respect to fair value, would you feel the same way if we were in an inflationary environment? **[TI 1/13, p. 4]**

Participant I-11
Yes. I may make inflation adjustments myself in my analytical work, but I'll do it based on my assessment. If I'm just presented with management's assessment of what it is, how do I know that I agree with that? **[TI 1/13, p. 4]**

Participant I-7
One of the beauties of our business is recognizing dramatic structural change. For example, just on the tax, we had to deal with going from APB 11 to FASB 109. To the extent that we have to live with change that is outside of our control, for example the changes that occurred in the financial services industry over the past 3 years, there is no way for me to get any idea of what the situation is for a company without getting fair value disclosure of its financial assets (for example for its HLTs). **[TI 1/13, p. 4]**

Committee/Staff/Observer
So you say "make the attempt to provide fair value"? **[TI 1/13, p. 4]**

Participant I-7
Yes, in notes. **[TI 1/13, p. 4]**

Participant I-8
I concern myself with real assets, not financial assets. Are you talking about having changes in fair value from year to year affect the income statement? **[TI 1/13, p. 5]**

Committee/Staff/Observer
We don't know yet. **[TI 1/13, p. 5]**

Participant I-8
I have a strong opinion on that. If you let that affect the income statement, I think it's wrong. There is just too much fluctuation. **[TI 1/13, p. 5]**

Committee/Staff/Observer
I would be interested in either [participant I-11] or [participant I-7]'s definition of financial assets. How do assets held for sale fall into the notion of financial assets that might be treated differently or the same as assets that are part of the normal operations? **[TI 1/13, p. 5]**

Participant I-7
Going back to the financial institutions, in the 50s, 60s, and 70s, we went through periods of volatility in terms of the real estate or the corporate finance marketplace. If there was volatility on the downside, the asset was put on the book at original cost; it was just set aside. My sense today is that there are much more requirements because of external demands for more marking-to-market. For example, [name deleted] had $5 billion of write-offs inside of

two years over three different time periods. After the second write-off, you normally assume that there is a third one coming; but the first was a shock, the second was a surprise. **[TI 1/13, p. 5]**

Committee/Staff/Observer
I'd like to follow up on a point made by [participant I-12]. I'd like to ask other members if you all think that fair value equates liquidation value. The reason I'm asking this is because fair value is defined a number of times in the accounting literature and it's always defined as some kind of value other than a liquidation value. For example, one acceptable way of estimating fair value for loans of a financial institution would be to take loans made last year at 9% and discount them using an 8% discount rate which corresponds to the current rate at which you would make that loan today. Would that still be a liquidation value? **[TI 1/13, p. 6]**

Participant I-12
Yes, because the underlying implication is that you could sell that loan at a rate that would equal the 8% return. **[TI 1/13, p. 6]**

Participant I-10
You're suggesting that the underlying creditworthiness has not changed. **[TI 1/13, p. 6]**

Committee/Staff/Observer
In my example, that hasn't changed. If it had changed, you would have to change your rate. **[TI 1/13, p. 6]**

Participant I-12
A critical point that [participant I-11] made is the reliability of the statements and whose judgment is applied to the statements, and what are the premises behind the statements. For example, in the real estate debacle of the last 5 years, an appraiser would go to a property in Massachusetts and would assign a certain value to the property. For my analytical purposes, I was looking at what is the ultimate write-off on bad real estate loans. I was taking the real estate loan portfolio and marking them down 30% for my own purposes. Now, do I want an appraiser coming every quarter and make that markdown? So I think there is an issue of whose judgment is being applied and the consistency of that judgment. It's an issue of reliability and of uneven application of principles. **[TI 1/13, p. 6]**

Also, how do you determine fair value for an instrument where there isn't even a market? I've securities people tell me they mark to market every day; why didn't [name deleted] mark down some of their loans long before they had to take big hits, if indeed they were marking to market? **[TI 1/13, p. 7]**

Participant I-14
Covering a broad range of industries over a long period of time, I would agree with [participant I-11] more than anyone I heard around here. I think you need a sense of stability somewhere. I think notational comments about fair value would be helpful but it can't eliminate the analyst's judgment. Fair value changes often enough. One of my favorites is lease accounting; I started when leases were a liability, and in the 1980s I was told they were assets, now they seem to be liabilities. Comments by management in footnotes would be helpful. [Also included in 8(c)] **[TI 1/13, p. 7]**

Participant I-8
My comments are based only on real assets. I've never analyzed financial companies, only companies that are in the manufacturing sector. Does it matter that a factory is worth half what it was 5 years ago in terms of its contribution to the manufacturing process? I don't think it's material. I would not want to see changes in fair value injected in the income statement. **[TI 1/13, p. 7]**

Participant I-12
Another example. If you're a bank, assume you make a loan to the local grocery store on December 31, 1991 at prime + 2 points. The grocery store keeps paying the loan back but suddenly the loan would be reflected at a different fair value because of a change in market interest rates. The economic value of that loan is unchanged because it's going to vary with the level of interest rate. But I can see cases where the balance sheet value of that loan might be changed because there is no market for that type of loan. **[TI 1/13, p. 7]**

Participant I-8
Can I ask a question? Let's say I own a million acres of land in Florida, I sell one acre for $100,000; can I take that transaction and say that's the value for a million acres? Or how else do I decide what the million acres is worth? Somebody's subjective judgment will be involved and you're are not going to come up with a number that even three people around this table would agree with. **[TI 1/13, p. 8]**

Committee/Staff/Observer
That suggests to me that your real concern is whether you can get believable information. What would you say if you had a million dollars of U.S. Treasury Notes? **[TI 1/13, p. 8]**

Participant I-8
I'll accept that there is a market value for that type of asset where there is an active market. I would accept marking that asset to market. **[TI 1/13, p. 8]**

Participant I-12
What if you had a million dollars in a private placement that has different pricing clauses in different environments and where there is no public market for it? **[TI 1/13, p. 8]**

Committee/Staff/Observer
I would ask you: if you could only have one number in the balance sheet for U.S. Treasury bonds, which one would you want in the balance sheet? **[TI 1/13, p. 8]**

Participant I-12
I'd go for the historical cost because I can always make the adjustment for any interest rate environment. I can pick the Wall Street Journal and look at the average balance sheet and the yield on those notes and then also adjust the liabilities. **[TI 1/13, p. 9]**

Committee/Staff/Observer
Then, what does the million dollars of Treasury bonds in the balance sheet tell you? **[TI 1/13, p. 9]**

Participant I-12
It tells me there is an asset of $1 million that's earning an average rate of 10% and the company is generating that dollar amount of interest revenue. Because I'm looking at the interest revenue and the interest expense. There's an awful lot of judgment that goes into estimating fair value; I'd rather use my judgment and apply it consistently. **[TI 1/13, p. 9]**

Committee/Staff/Observer
[Participant I-12] if one of the companies that you follow had two lines of business and it made a decision to get out of the retail side of the business and it was anticipated that the sale of that business was significantly higher than the book value of those assets and liabilities, would you still opt for historical-cost-basis financial statements in connection with those assets and liabilities or for an estimated fair value for the business? **[TI 1/13, p. 9]**

Participant I-12
I believe we have an accounting principle that companies use for discontinued operations. **[TI 1/13, p. 9]**

Committee/Staff/Observer
But they don't anticipate the gains. **[TI 1/13, p. 9]**

Participant I-12
I can tell you a number of instances where a sale of a business has taken place at a third of the price the company said it would sell it for. **[TI 1/13, p. 9]**

Committee/Staff/Observer
So again your concern is reliability. **[TI 1/13, p. 10]**

Participant I-12
An issue you have brought up that has gotten a lot of attention is this notion of "held for sale". There is a fundamental operating principle in the world of banking or any lending operation.

That is, there are times when there's a lot of investments you want to buy or a lot of loans you want to make. There are also times when nobody wants to borrow. Historically, in the world of banking, treasury securities have been used as a liquidity reserve. In some cases, they will hold those for long periods of time, in other cases they won't because they don't know when the economic environment is going to change. It seems to me that the emphasis on held for sale might be somewhat misplaced. **[TI 1/13, p. 10]**

Committee/Staff/Observer
Let me give you a second part of question 1. Right now, in the accounting standards, fair value information creeps into the financial statements. A basic example is when companies report investment in marketable equity securities at market value when that value is below cost. In some cases, even though some items may be measured at historical cost, companies disclose fair value in the notes. For example, FASB 107 on fair value of financial instruments. Another example is under the old FASB 33 with inflation accounting. Our question is; despite seemingly negative opinions about fair value accounting, do you use fair value information in your work? If so, when and how? Some examples would be helpful. **[TI 1/13, p. 10]**

Participant I-12
The primary fair value item that financial analysts look at is cost vs market in the investment portfolio. I look at that periodically to see if a company has gains or losses, and then I look at what cash flows those assets are generating. I don't use it very much. I typically will look at a company and make adjustments depending on the environment. For that, I use average balance sheets; that's what is useful to me. Fair value disclosure is really not of that much use. [Also included in 1(b)] **[TI 1/13, p. 10]**

Participant I-8
The problem I have is you want to address the question of fair value across all types of companies and types of operations, and I think you're not going to get anywhere with that. **[TI 1/13, p. 11]**

Committee/Staff/Observer
That's the next question. This question is how do you use fair value information that is available now? Or if you had more, how would you use it? For example, if you're looking at a company that paid $4 an acre for real estate, and you know that they sold one acre for $100,000, would you use that information? [Also included in 1(b)] **[TI 1/13, p. 11]**

Participant I-8
I would try to in a security analysis sense, not in an accounting sense. [Also included in 1(b)] **[TI 1/13, p. 11]**

Participant I-7
For most of my manufacturing companies, I'm depending on the accounting profession now to look at what I consider fair value. I'm assuming that the accountants, in conjunction with management, are looking at receivable accounts and at inventory and they're giving me a measurement of fair value to some extent through a reserve account. I may get that information only once a year but I use that information. I can look at that reserve account through a number of years. But my problem is not necessarily in the manufacturing arena, it's in the financial arena. **[TI 1/13, p. 11]**

Participant I-14
I think we all make the mental adjustment and use fair value a lot more than we're willing to admit. That's part of our job because what we're trying to do is determine earning power, fair value of a whole company, as compared to the price of its paper. How many times do you look at the current price for a semiconductor and you look at a balance sheet and there is $50 million of inventory that you know has just gone down; you make that adjustment. This is ongoing and we do it all the time. I would opt for fair value on a notational basis. [Also included in 1(b)] **[TI 1/13, p. 11]**

Participant I-8
You are in some sense already using fair value when you accept the depreciation life that the management of the company is giving for the manufacturing assets. [Also included in 1(b)] **[TI 1/13, p. 12]**

Committee/Staff/Observer
That's an impairment concept. It's the lower of cost or market concept as opposed to fair value. I agree with what [participant I-7] said, that we do make reserves to make sure that the values are at least realizable. But on the upside, taking the example of the semiconductor, we don't, even notationally, talk right now about the increase in value of that inventory. [Also included in 1(b)] **[TI 1/13, p. 12]**

Participant I-8
But it gets into what is the value added by the enterprise you're looking at and the accounting has to be appropriate to that. If the company is speculating in semiconductors and doesn't do anything else, then fair value is appropriate. If I'm converting raw silicone, and there are big margins because of value added, should the accounting be the same as the guy whose not adding any value? **[TI 1/13, p. 12]**

Committee/Staff/Observer
Our accounting model today is a mixed attribute model. It's not purely historical cost; in some circumstances, we do make value adjustments in financial statements. Based on what you've said, one might argue that we should change that and go to a purely historical cost system, and eliminate any value adjustment that we have today and reflect those in the footnotes. Is that a logical conclusion? **[TI 1/13, p. 12]**

Participant I-12
I could go for that. I thought depreciation represented a decline in economic value because of the wearing out of the assets. I don't know if that's the same as the fair market value that we're talking about here. **[TI 1/13, p. 12]**

Committee/Staff/Observer
Let's go back to the example that [participant I-14] gave of the inventory. Under present accounting rules, if market value is lower than cost, the company would write the inventory down and report that in the financial statements. Alternatively, we could propose that it continues to report the cost and explain by footnote that the cost is in excess of market value at that date. That would be a pure cost system; you would know that every number on the balance sheet is cost and only cost. **[TI 1/13, p. 12-13]**

Participant I-12
I would be happy with that. **[TI 1/13, p. 13]**

Participant I-5
We are using fair value accounting on the down side but not on the upside. And all of us would agree that we should mark to market as quickly as possible on the downside. The logical extension is that if you mark to market every asset, then presumably it should represent the value of the business. Therefore, if we just mark the equity on the balance sheet to market, which is the stock price, we're done. We just divide up the total equity value between the company's assets. **[TI 1/13, p. 13]**

Committee/Staff/Observer
It won't add up. **[TI 1/13, p. 13]**

Participant I-5
Then there are some assets that you're not ascribing a value to. **[TI 1/13, p. 13]**

Committee/Staff/Observer
Goodwill. **[TI 1/13, p. 13]**

Participant I-5
Put it on there. **[TI 1/13, p. 13]**

Committee/Staff/Observer
At one extreme, we could propose a model whereby each item in the financial statements is measured at some type of value. At the other extreme, we could propose a model whereby each item is measured at cost. Or we could adopt some kind of hybrid method where items would be measured at cost whenever value information is not important, and at value when value is most relevant to your work, depending on certain conditions. This conditional

approach is the subject of the next part of the discussion. The first part of our question is: under what circumstances would you prefer to have fair value information recorded in the financial statements? That is, where fair value becomes the primary measurement basis. **[TI 1/13, p. 13-14]**

Participant I-7
When it happens today, that is, when the transaction takes place. In that case, I get fair value. So I don't have to ask you to do anything for me, from a manufacturing point of view. **[TI 1/13, p. 14]**

Participant I-8
I don't think fair value has any place in the financial statements where the value added is not related to the assets that are there. **[TI 1/13, p. 14]**

Committee/Staff/Observer
In the manufacturing arena, if a company you follow has some nonoperating assets, would your preference be historical cost or fair value for those? **[TI 1/13, p. 14]**

Participant I-8
I can accept fair value there, and in fact, you usually get that when a company discontinues an operation; it attempts to put a fair value on that discontinued operation. You should go back and see how close those numbers are to the price that they actually realize subsequently when they dispose of the operation; my guess is that it's not very close (not even plus or minus 10%). **[TI 1/13, p. 14]**

Participant I-11
What we're really talking about here is a continuum of assets. A T-Bill is easy because that's like a dollar bill. 100,000 shares of IBM is pretty easy. 100,000 shares of some of the stock I follow is less easy and so on down on the continuum. My position is that the starting point for the financial statements ought to be historical cost. And there ought to be some very persuasive reasons to do anything but that historical cost. I think you can make a strong argument for marking to market on marketable securities. I think you can make a weaker argument on securities that don't have public markets. And as you go down the continuum, the argument gets weaker and weaker. But the more I think about it, I think that we should really double check and triple check before we get away from historical cost. That's the benchmark. It seems to me that the role of the accounting profession is to take the books of the company and presents them to users in some understandable form. The role of the financial analyst is to take those statements and manipulate them for some purpose; equity analysis, credit analysis, or whatever it may be. I think we have a tendency to want to ask the accounting profession to do our job. My last comment is that I don't have any problem with that time-honored principle of recognizing losses and deferring gains. **[TI 1/13, p. 14-15]**

Committee/Staff/Observer
I don't think we should think about this subject in terms of impinging on the analyst's job. If what you do with the historical cost financial statements is an automatic adjustment to make them better, shouldn't we do the something better first, if it's so obvious? **[TI 1/13, p. 15]**

*Participant I-12*A key underlying accounting assumption is that a company has an economic value or purpose. It seems to me that historical cost adjusted for economic events that affect a company is a valid approach. In some respects, if you adopt a market value accounting approach, you're impinging on the analyst's job because people have different opinions and judgment about the fair value of assets. **[TI 1/13, p. 15]**

Participant I-5
One place fair value is used now is for liquidating banks; that should remain. Although different people have different opinions about the right number for fair value, even if you're off by 10%, it's better than the variations you get when you look at old historical costs. I don't know how much sense the time-honored tradition of recognizing losses and deferring gains make. **[TI 1/13, p. 15]**

Participant I-11
The one time you really know what the fair value is when the transaction occurs. That's why I say let's stay with the historical cost because we have a transactional model. **[TI 1/13, p. 16]**

Participant I-7
Is there a concern on the part of the accounting profession that if market value is disclosed in footnotes, that if the information turns out subsequently not to be correct, that it could be used against the people who make the fair value adjustments? [Also included in 18(b)] **[TI 1/13, p. 16]**

Committee/Staff/Observer
That's the second part of the question, which deals with fair values being disclosed rather than being recognized in the financial statements. In that case, let's not talk about the liability issue. **[TI 1/13, p. 16]**

Participant I-7
I want historical cost information in the financial statements, and notational disclosure of fair values. **[TI 1/13, p. 16]**

Committee/Staff/Observer
[Participant I-12] said that part of determining fair value depends on what your expectations are as to how you are ultimately going to realize the asset or settle a liability. Even if you want to adjust the information you receive, why wouldn't you want to know what management's expectations are with respect to fair value? [Also included in 2(b)] **[TI 1/13, p. 16-17]**

Participant I-12
Management lies all the time. [Also included in 2(b)] **[TI 1/13, p. 17]**

Committee/Staff/Observer
So it's a reliability issue? [Also included in 2(b)] **[TI 1/, p. 17]**

Participant I-12
Yes. [Also included in 2(b)] **[TI 1/13, p. 17]**

Participant I-10
Have you ever seen a management who thought that their stock was overvalued? With fair value, you're giving them a platform to induce people to believe that there is an enormous gap between what the market price is and what they believe the business is worth. I think that plenty of room would be given for deception. Not everyone is a professional investor; there are millions of people who believe what th ey read! It's somewhat dangerous. [Also included in 2(b)] **[TI 1/13, p. 17]**

Committee/Staff/Observer
Certain fair value information can be influenced by management, but historical cost information is the result of management's decisions. The one number that is not affected by management is market price. So why shouldn't we want to get market price rather than either historical cost or some estimate of fair value? **[TI 1/13, p. 17]**

Participant I-7
Because market price might not be reflective of future prices, depending on how fast realization will take place. When you can get market price every day at the end of the day, you do it. But what happens if you have assets where there is no market price? **[TI 1/13, p. 17]**

Committee/Staff/Observer
But there are market prices for a lot of assets that we do not now mark to market, such as automobiles. **[TI 1/13, p. 18]**

Participant I-15
Going back to management's perceptions. When you look at some of the opportunities that companies take, when they realize a large gain, to do these restructuring charges and write-off assets, it shows you that management is often shortsighted and unreliable. You can't believe what management tells you many times. [Also included in 2(b)] **[TI 1/13, p. 18]**

Participant I-12
Going back to the question of why don't we just use market value? The market is nothing more than a value at a point in time. All the market is collective judgments as to the fair

market value at a point in time. I'm saying that those judgments have a lot of unreliability in them. Is Citicorp really worth $8.50, the price it closed at the end of 1991, or is it worth $21.50? Those differing prices simply reflect the collective decision-making of analysts. I'm not convinced that that's an appropriate benchmark that gives us the kind of reliability and stability that we need to make our own judgments about what the market might do. We're getting into some circular logic here that bothers me a lot. [Also included in 2(b)] **[TI 1/13, p. 18]**

Committee/Staff/Observer
Is the last transaction price, if readily available in the market, a good surrogate fair value for what might be the next transaction? I think you may get a different answer on a government bond versus a sale of real estate in Houston when there is 50 properties available and there is only one sale. Some people on the regulatory side would say take that one sale and use it as fair value. Others would say you can't do that because it's a distressed value, not a reflection of future value. **[TI 1/13, p. 18]**

Committee/Staff/Observer
Same example. I'm the accountant for the 51st property, the one who bought at 9 times the current market. He paid the highest price ever paid in Houston for the building. I'm producing the financial statements for that company. You know, I know, everyone at this table knows that financial statement is overstated and wrong. To me, there is got to be a mechanism for marking down that misleading financial statement. **[TI 1/13, p. 19]**

Participant I-11
I have no problem with doing that notationally. But that is not wrong. The fact is that the client did pay a high price for the building and that's the fact; a transaction occurred. So it's not wrong to say that this is the transaction that occurred. Is it the present value of that property? No, clearly it's not. What is the present value? That's where we get into the subjectivity. We get back to the question of how you determine fair value? A T-Bill is pretty easy, but even for marketable securities you can get into some issues about the extent to which the market price is representative of the obtainable price for the block you're dealing with. **[TI 1/13, p. 19]**

Participant I-12
Going back to the example of the 51st property in Houston. The question is who is the buyer? Is it Exxon Corporation making the property its headquarters and they intend to occupy it permanently? Or is it O&Y and they're speculating? You get a different result on what is the economic value of the building depending on the identity of the buyer and the purpose of the purchase. **[TI 1/13, p. 20]**

Participant I-8
In that example, what number are you going to record in the financial statements as the fair value of that 51st property? **[TI 1/13, p. 20]**

Committee/Staff/Observer
The answer is there is no one number, but it's clearly something less than the excessive price paid. **[TI 1/13, p. 20]**

Participant I-8
If you put an intelligent estimate of fair value in the financial statements, it will get dignified to an extent greater than it should. Whereas if you have notational presentation and you're able to describe the subjectivity involved, it doesn't get dignified to the same extent. **[TI 1/13, p. 20]**

Participant I-7
Still on that example, the question is whether it is fair to ask the accounting profession to make an assessment of what the fair value of that property is and will be in the future. **[TI 1/13, p. 20]**

Committee/Staff/Observer
[Participant I-12], I believe you said that what's important is economic value. Would you describe what you mean by economic value? **[TI 1/13, p. 21]**

Participant I-12
It has to do with the going concern value. In the manufacturing sector, for example, you have a plant that make widgets. The economic value of that plant is the discounted value of cash flows generated by all the widgets they make. **[TI 1/13, p. 21]**

Committee/Staff/Observer
What would be the economic value of a long-term bond? **[TI 1/13, p. 21]**

Participant I-12
Let's look at a financial company whose purpose is to intermediate funds. For example, a bank receives a deposit placed in a 5-year CD (at 5%) and buys a 5-year Treasury note at 7%; the maturities are matched. If interest rates go up, the value of the bond goes down but the value of the deposit goes up, so the two are a wash. **[TI 1/13, p. 21]**

Committee/Staff/Observer
So, even though the economic value is more important than the cost, you would still say that the cost should be reported in the financial statements? **[TI 1/13, p. 21]**

Participant I-12
Yes. In the particular example I use, you assume that a decline in the fair value of the asset is offset by the decline in value of the liability, so the two are a wash theoretically. **[TI 1/13, p. 21]**

Committee/Staff/Observer
Two questions addressed to [participant I-7] in the context of a manufacturing company. You mentioned that even though we may not recognize and measure fair values on the balance sheet, you would still encourage them to be in the footnotes. Was that meant to be directed to financial assets and liabilities only or to operating assets and liabilities as well? **[TI 1/13, p. 21]**

Participant I-7
I'd like to see operating asset values as well. **[TI 1/13, p. 22]**

Committee/Staff/Observer
My second question is whether you would agree that fair value measurement is more relevant when an operating asset becomes an asset held for sale? **[TI 1/13, p. 22]**

Participant I-7
Yes, in that particular situation. Are you putting it under APB 30 rules? **[TI 1/13, p. 22]**

Committee/Staff/Observer
Yes.
Participant I-8
I thought you already were trying to measure those at realizable values. **[TI 1/13, p. 22]**

Committee/Staff/Observer
Yes, but that's different from fair value. **[TI 1/13, p. 22]**

Committee/Staff/Observer
We can couch that question not in terms of assets held for sale, but in terms of nonoperating assets, which might include assets held for sale but also investments of the manufacturing entity. How would you like to see nonoperating assets treated in financial statements? **[TI 1/13, p. 22]**

Participant I-7
To the extent that management feels that there is a major downside risk, I want it noted. **[TI 1/13, p. 22]**

Committee/Staff/Observer
Last question on fair value, which deals with the volatility or "noise" issue in reported earnings. First, do you agree that fair values in financial statements would introduce unhelpful noise in reported earnings? Anybody think it will not introduce unhelpful noise? The answer seems to be no. Next question: would your answer to this question differ depending on how the impact of fair value measurements is reported in the income statement? [Also included in 2(b)] **[TI 1/13, p. 22-23]**

Participant I-7
And reliable? [Also included in 2(b)] **[TI 1/13, p. 23]**

Committee/Staff/Observer
Take the reliability issue off the table. [Also included in 2(b)] **[TI 1/13, p. 23]**

Participant I-11
I don't think you can separate those issues. My complaint is this notional fair value is fundamentally an unreliable number. What is the fair value of the [large commercial office building]? [Also included in 2(b)] **[TI 1/13, p. 23]**

Participant I-8
If I am not mistaken, there is already a distinction made in the income statement in the way in which accounting is done for earnings of foreign companies depending on whether the currency is considered to be stable or the "banana republic" type thing. The accounting profession is saying that in the latter case, the accounting will be done a specific way because the currency fluctuations should stay within a specific band. [Also included in 2(b)] **[TI 1/13, p. 23]**

Committee/Staff/Observer
There is no interest for running value changes through the income statement. I'm wondering what your reaction is to the accounting in the pension arena when value changes are in effect spread to eliminate volatility. That's kind of a compromise in the market value arena; is that good or bad? [Also included in 2(b) and 9] **[TI 1/13, p. 23]**

Participant I-7
You're not in the business of putting businesses out of business. In some instances, if you didn't spread, you would really create a problem. [Also included in 2(b)] **[TI 1/13, p. 23]**

Participant I-8
I think it's good; it reflects the realities of the world and to that extent it's good. The real question is whether the actuarial assumptions are valid or not, not the interim fluctuations in the assets that happen to be held at that moment. [Also included in 2(b) and 9] **[TI 1/13, p. 24]**

Participant I-12
I have a problem with the actuarial assumptions. We all know of companies that are still using 7-10% accumulation rates. This comes back to the notion of reliability. I don't have a problem in trying to reflect in some manner the cost of employee health care benefits; on the other hand, what happens if we socialize medicine and get deflation? [Also included in 2(b) and 9] **[TI 1/13, p. 24]**

Participant I-5
The question of reliability is fine and good, but the fact is the present historical book value that is recorded is significantly less reliable than someone's best guess of fair value today in 95% of the cases. For example, Rockfeller center gets an appraisal every year; $1.8 billion 4 years ago, then $1.7 billion, then $1.6 billion. Meanwhile, the bond is trading as if it's worth maybe $700 million. If the company shows it in the balance sheet at historical cost of $600 million and didn't tell you about the $1.8, $1.7, and $1.6 billion, what is the best measure? I think the best guess of what someone says it's worth today is valuable to have relative to what the cost was in 1936. [Also included in 2(b)] **[TI 1/13, p. 24]**

Committee/Staff/Observer
It seems that what I'm hearing is that historical cost information is important not for the dollar amount that is attached to the cost but for the other information that comes along with it. You know about what the asset is, how it is being used, and its terms. You're not using the dollars that are attached to it, but you want the information so you have the information necessary to you to apply your own judgment as to value. You don't want the fair value information in the financial statements even though it might be more relevant than the historical cost dollars because of concerns about reliability. **[TI 1/13, p. 24]**

Participant I-7
Therefore, why would we change historical values? **[TI 1/13, p. 25]**

Committee/Staff/Observer
If you're looking at two companies, one bought a plant in 1992, the other in 1980, so there is a significant difference in costs of acquisition. They both sell the same products to the same customers. How would your analysis be affected, if at all, because the cost structures of the companies would be different? [Also included in 2(c)] **[TI 1/13, p. 25]**

Participant I-12
Theoretically, on an economic value basis, the two companies selling the same products at the same price ought to be worth the same amount of money. Although there might be some difference in efficiency or deficiency. [Also included in 2(c)] **[TI 1/13, p. 25]**

Participant I-7
The real market is not going to reflect that; it's looking at the bottom line. [Also included in 2(c)] **[TI 1/13, p. 25]**

Participant I-5
The financial statements of those two companies are going to look radically different, but you're telling me that they should be valued the same. The only way I'm going to find out that they should be valued the same is to go back and figure out what years the companies bought their plants. I'm going to look at cash flow from operations and required capex to

keep you at the same level. It's a much more convoluted process than it would be if the statements were identical. [Also included in 2(c)] **[TI 1/13, p. 25]**

Participant I-12
If you're looking at cash flow, the only impact that transaction has on the income statement is the depreciation and the interest expense. [Also included in 2(c)] **[TI 1/13, p. 25]**

Participant I-14
On the manufacturing company, I find it very hard to believe that the building that was put up in 1980 has not had substantial modifications to produce a product that would be sold in 1992 and that would be reflected in the equipment account. Where something like this would be more appropriate is in the retail field where there are always changes. Also, since retailers predominantly lease, the cost of the leases has an enormous impact on the bottom line. So I think that the more realistic question would relate to retailing rather than manufacturing. [Also included in 2(c)] **[TI 1/13, p. 25-26]**

Committee/Staff/Observer
If you want a last word on fair value accounting, speak up now. **[TI 1/13, p. 26]**

Participant I-11
Don't do it. **[TI 1/13, p. 26]**

Participant I-12
Yes, don't do it. **[TI 1/13, p. 26]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality. During the discussion, comments were made on the volatility of value information.

*Committee/Staff/Observer*The last question about volatility is: what problems related to volatility do you have with the information you receive from external financial reporting? The meeting materials on page 11 identified 4 possibilities. [Also included in 2(b)] **[TI 3/17, p. 33]**

Participant I-12
Fair value accounting. Running changes in the value of a bond portfolio through the income statement is going to make that statement incredibly volatile, and it may be a faked volatility because those quarterly gains or losses may or may not be realized. For example, anybody who sold their stocks November 1, 1987 probably realized substantial losses; anybody who waited 6 months probably made out just fine. So the realization of gains and losses is vastly

different from the paper effect. Fair value accounting would just make the volatility of earnings that much worse. [Also included in 2(b)] **[TI 3/17, p. 33]**

Participant I-16
Does that make it worse or does that just recognize the reality? [Also included in 2(b)] **[TI 3/17, p. 33]**

Participant I-12
What's reality? [Also included in 2(b)] **[TI 3/17, p. 34]**

Committee/Staff/Observer
I don't want to get into an argument but I could argue that the November 1 person holding the securities as opposed to the person who sold those securities is not presenting a very correct balance sheet. I'm not talking about how to handle that in the income statement, that's a different issue. [Also included in 2(b)] **[TI 3/17, p. 34]**

Participant I-12
But in terms of volatility, that would introduce volatility in the income statement that wasn't there before. [Also included in 2(b)] **[TI 3/17, p. 34]**

Committee/Staff/Observer
Assuming you put the unrealized November 1 loss in the income statement. [Also included in 2(b)] **[TI 3/17, p. 34]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on value information.

Participant C-5
The dilemma that's being expressed is that price and value are the same at any point in time, but price and value are different. I don't believe the markets have actually woken up to that. There is continually this dilemma of trying to chase price and claiming that's value. I think the accounting profession has to be careful because they're following, and they're getting into this same chase. [Also included in 1(a)] **[TC 12/8, p. 5-6]**

Committee/Staff/Observer
Can you identify some of the accounting that you think is chasing that incorrectly? [Also included in 1(a)] **[TC 12/8, p. 6]**

Participant C-5
Well, mark to market obviously. [Also included in 1(a)] **[TC 12/8, p. 6]**

Committee/Staff/Observer
[Participant C-5], are the implications of that the same whether it's a debt instrument or whether it's an equity instrument? [Also included in 1(a)] **[TC 12/8, p. 6]**

Participant C-5
Yes. We see this particularly in real estate, more so right now than even in commercial credit. I think some sanity has returned to the commercial markets, but right now we are claiming that real estate value is in fact real estate price, and we are particularly troubled because we can see a tremendous disequilibrium. Risk of decline has been removed from that market, the discounts required in that market are still substantial. We basically are selling properties at 12 times cash on cash, or 12% cap rates, or eight times cash on cash yields with a relatively locked in income stream. We can see the disequilibrium, and we just don't know when the balance will come back, but that's the whole game of investing debt or equity. [Also included in 1(a)] **[TC 12/8, p. 6]**

Committee/Staff/Observer
I would have thought the significance of that might vary whether you're talking about real estate, whether you're talking about an equity instrument, or whether you're talking about a debt instrument, depending on where it sits in a liquidation priority. [Also included in 1(a)] **[TC 12/8, p. 6]**

Participant C-5
Well, that's true. As you come closer to the question of customer viability, then liquidation and price risk becomes particularly relevant. But as you move away from that, it becomes less relevant. The lower you get on the debt structure, the more you look like equity, and so the closer you are, the more it becomes important. [Also included in 1(a)] **[TC 12/8, p. 7]**

Participant C-11
I'd also say . . . that there is something missing, which is more balance sheet related items. I happen to be more emphasizing in my own work on analysis of financial intermediaries, and an extremely important thing that you analyze is the trend of various loans or investments or deposits, or whatever the items may be. This seems to be missing from all of the elements here. Your trend analysis of various balance sheet items is just as important as the trend analysis of revenues or costs. The emphasis on balance sheet items also gets me into a discussion of mark to market in the sense that if you mark to market your financial statements, number one, you lose all those trends, but also you are departing from cash in the sense that your loans and investments after all do end up getting paid at a stated amount at some maturity date. And so for several reasons I think that the accrual and cash accounting tables and

analysis are both important, and then secondly I think the balance sheet has to be brought into a lot more focus on these bullets. [Also included in 1(a) and 1(c)] **[TC 12/8, p. 9]**

Participant C-6
Just to pick up a little bit on what [participant C-9] said, but from a different point of view, looking at, again, privately-held companies, which is what we deal with. We look at granting credit in a very traditional way, looking at historical information. We don't place a lot of faith on projections, and we look at a very traditional aspect of cash flow: profitability. As far as asset value, we place a fair amount of emphasis on asset value, meaning the primary assets of the companies that we deal with (accounts receivable and inventory) and knowing what those assets comprise of, and what the quality of those assets are, which is of utmost importance to us. [Also included in 1(a) and 1(b)] **[TC 12/8, p. 11-12]**

Participant C-3
When you look at a large financial institution, the biggest question that pops up is whether the accounting model that we're using is right. That focuses on the mark-to-market issue. The investment portfolio discussions that have gone on is really just the tip of the iceberg. In looking at some of the companies that I look at, segments become the secondary issue; how you determine earnings is the number one issue, or what are the earnings of a company. [Also included in 5(a) and 15] **[TC 12/8, p. 28-29]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information.

Committee/Staff/Observer
I would like to address the first set of topics which has to do with fair values and market values at the beginning of page 4 of your meeting materials. Looking at the bottom of page 4 [of the meeting materials], I'd like to call your attention to make sure we're focusing on the same definition. Fair value is the Financial Accounting Standards Board's definition of fair value, which is the amount at which the asset--or you could substitute liability if you wish--could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. Therefore, where there is a market, market value and fair value are deemed to be the same. As a creditor, do you consider fair values? And if so, do you consider fair value for all assets and liabilities? And if you do, what are the sources, that is, where do you get that information, even if it's only for some selected assets and liabilities and for what purpose do you use that information? **[TC 2/2, p. 1]**

Participant C-13

I would accept the definition of fair value that you've given as a reasonable definition of fair value. But, from the point of view of the fixed-income investor, there would also be a consideration of what the value could be in a forced liquidation setting. **[TC 2/2, p. 1]**

Participant C-2
Generally, I think particularly for major assets or selected assets, you would consider a range of values of which liquidation value might be at the bottom and book value is going to be in there somewhere, and also fair value. You compare those values and use them in your analytical work, certainly. But looking at liquidation values is important to me. **[TC 2/2, p. 1-2]**

Participant C-7
From a banking standpoint, our focus is on that which we've taken for collateral, generally fairly specific tangible assets as opposed to trying to value the intrinsic value of a business. We really don't get concerned with value until we are in liquidation. [Also included in 1(a)] **[TC 2/2, p. 2]**

Committee/Staff/Observer
Are you saying that ability to recover amounts otherwise uncollectible are where you're coming from? [Also included in 1(a)] **[TC 2/2, p. 2]**

Participant C-7
Yes. [Also included in 1(a)] **[TC 2/2, p. 2]**

Participant C-11
Before we talk about valuation of a specific loan or whatever it might be, I think we have to recognize, from the beginning, that we're dealing with a business, the business of financial intermediaries, where 90% or whatever of the assets and liabilities are financial instruments. For a bank or an insurance company, you're using the assets and liabilities to keep track of factors such as the amount of growth in the business and the interest rate sensitivity risk. In other words, you look at whether the assets and liability are reasonably well balanced in terms of what might happen if interest rates go up and down and all that. In my mind, those are reasons why the historical cost model should be retained as opposed to moving to a fair value model. The historical cost framework is very important in knowing what's going on. So there's more to this than just valuation of specific balance sheet items. There's a whole business that we're dealing with, and what are the risks and what are the rewards in that business. And the content of historical cost numbers, to my mind, are critical to that. **[TC 2/2, p. 2]**

Participant C-2
I wouldn't be advocating use of fair value as recognition in the financial statements. I think it's important additional information that I consider, but I very much support the continued use of historical cost as the model and the framework. **[TC 2/2, p. 2]**

Participant C-4
We rely on the consistency and comparability of historical cost analysis. I don't think that the information we'll be getting from an auditor on fair market value is information that would not otherwise be available to us. We feel that historical cost consistency is much more important in our analysis than fair market value. [Also included in 2(c)] **[TC 2/2, p. 3]**

Participant C-15
Maybe it's helpful to view assets in two classes--financial assets and fixed assets. For fixed assets, you're interested in return on assets rather than what do we get in liquidation or an orderly sale. For financial assets, we would tend to look at the difference between the book and market value. **[TC 2/2, p. 3]**

Participant C-17
One of the difficulties with fair market values is they're so volatile. As additional information, it's helpful, because it gives you a reference point. Knowing what the spread is and getting some sense of fair market versus historical is important. I don't base my decisions solely on it. The thought that comes to me is sometimes, if I'm trying to choose between a secured and unsecured debt, for example, I may want to factor in how much capital support is really there. And I may be swayed to some extent by the reliability of the values that I see. You use fair values with a certain amount of prudence. [Also included in 2(b)] **[TC 2/2, p. 3]**

Participant C-14
I would agree with [Participant C-15] comment on fixed assets; our approach is that fair market value of fixed assets will be reflected in profitability As an example, McDonald's have enormous undervalued real estate holdings, which provide a creditor with a great deal of comfort of the secured basis. But, in theory those undervalued real estate holdings should show up in the firm's profitability. **[TC 2/2, p. 3]**

Committee/Staff/Observer
In this group and in discussions with other, we've heard a lot about two sets of market value and fair value information. One of the things that I personally as a committee member have tried to sort through is how all of you use supplemental information versus primary information and which is more important in different circumstances. In what circumstances do you become much more interested in market value information versus historical cost? **[TC 2/2, p. 3]**

Participant C-17
I get real interested in what assets are worth or what the fair market value is the more I rely on security or also as a way to try to evaluate an extra strategy if the company fails. But in the normal course of business, I'm going to be looking to the ability of the company to pay, I don't want to liquidate the company in order to get repaid. I'm looking at that more as a

backstop. I look also at market value to make the decision as to whether or not and what type of collateral I need. [Also included in 1(a)] **[TC 2/2, p. 4]**

Participant C-4
As the more distressed the situation becomes, we start focusing our attention on the liquidation values, and at that point, we may not necessarily be relying on what a CPA audit tells us. We may actually go to an expert and get some appraisals ourselves, which would be beyond the scope of the normal audit. To have fair market value information included in an audit is not something that is of great benefit to us normally. It's nice to have as an additional disclosure. [Also included in 17(b)] **[TC 2/2, p. 4]**

Participant C-17
The thing that concerns me is that we start talking about trying to throw into the normal reporting process fair market values. What that generally means is you're going to have a whole lot of adjustments on an annual basis through the income statement, or either directly in equity. That means that I've got to spend more time trying to figure out what's the real cash flow. I've never really liked that, never really felt comfortable when that kind of thing has occurred. I don't want it to interfere with my ability to try to determine that the company is an ongoing enterprise and how well or poorly it's doing. **[TC 2/2, p. 4]**

Committee/Staff/Observer
[Participant C-4], I thought I heard you say that when the situation gets more distressed, you're looking at the liquidation value. So comparing that to the page 4 definition, simply you bypass that type of fair value, "a willing buyer seller other than forced sale or liquidation basis". Is that not of interest? If we gave you that information, do you do anything with that information or do you want that information? **[TC 2/2, p. 4]**

Participant C-4
In most cases, liquidation value would probably be less than the fair value notion you use. But we would use this information as an aside, yes. We feel there is some value to it. **[TC 2/2, p. 4]**

Participant C-17
When you're a lender, you never sell at fair market value. You're basically at an auction, or you're dealing with a "workout specialist" who's basically trying to shepherd the company from bankruptcy. So your notion of fair value is a reference point, but we would never expect to get that value. But it is a good reference point. **[TC 2/2, p. 5]**

Participant C-4
I think it's easier to determine what the fair value is as opposed to the liquidation value. In that respect, since that information is readily available we prefer to use it. **[TC 2/2, p. 5]**

Participant C-2

I think the fair value compared to book value becomes useful if you know management intends to sell the assets or is preparing the business for sale. **[TC 2/2, p. 5]**

Participant C-13
The historical cost model seems to suit our requirements the best. But fair value information, providing you can satisfy yourself as to reliability, is important, particularly if there's a large disparity between fair and book value. The McDonald's example is a good one on one side. The life insurance industry in the 1980's is a good example on the other side, where the much lower market values book indicated some pressures and strains on the industry. [Also included in 2(b)] **[TC 2/2, p. 5]**

Participant C-14
To answer the question as to whether fair value is useful, I'd say it is in cases of material upgrading of assets or when a possible sale is a potential source of liquidity. **[TC 2/2, p. 5]**

Participant C-15
The footnote type of disclosure would be more useful to creditors and sophisticated financial analysts rather than having the values on the balance sheet bounce all over the place. For example, a number of years ago when interest rates were high and a lot of banks' government bond portfolios were under water, if you'd marked bank's assets to market you'd basically wiped off their government securities portfolio and their net worth. And a year later, interest rates declined and those asset values increased. **[TC 2/2, p. 5]**

Committee/Staff/Observer
Something I thought I saw in S & P's green guide said that a company's ability to service its debt is not affected by its market value. **[TC 2/2, p. 6]**

Participant C-15
I would think it would. Looking at McDonald's again as an example: they have a very high debt to equity ratio because they're carrying their assets at historical cost. We would mark those assets to market. **[TC 2/2, p. 6]**

Participant C-5
Historical cost may be one reference to what actual value is. Current price is your supposed fair market value in a non-distressed situation. In making decisions, you have to understand the likelihood that market value will return to some reference point. One of the problems with market value is many markets are inefficient--the real estate property market being the most inefficient, just because of the way it's driven by tax incentives and the like. It takes a while for these markets to find equilibrium but we have to understand that underlying all that, there is a real value. As a lender, it is true we don't take into account market value, not just because we don't necessarily believe the approach that's been used, but also because we don't get the detail of all the assumptions that went into the estimates. Without knowing all those assumptions, and you could never give us all those assumptions in a set of disclosures, we would have to go in and make our own set of assumptions and revisit the estimates anyway. Large corporations, particularly, is the one area where we would advance funds without knowing market values. And in secured lending situations, non-investment grade, it really adds no value to us. [Also included in 9] **[TC 2/2, p. 6]**

Committee/Staff/Observer
[Participant C-5], one of the arguments you hear for fair value is the relevance argument. That is, fair value is always more relevant than historical cost. I think what I heard you say is it may or may not be in your situation. Because of not knowing the assumptions that go into it, and the timeliness of it, that may not be any more relevant than other information you have. [Also included in 2(a)] **[TC 2/2, p. 6]**

Participant C-5
For example, you could have given me a perfect real estate fair value in 1988. And knowing that the land had flipped three times in the course of the last three years, a good lender would

have been smart enough to figure out it wasn't worth $500,000 then $1 million, and then a million and a half. And each time an accountant had good comparable sales, analysis and so forth, it could have given you a number showing significant increases. Realizing that this thing was getting into a disequilibrium, a lender knowing historical costs would have been smarter to focus on that than on fair value. Fair value can be misleading. . . . [T]imeliness is so critical. Even trade receivables. You could give me year-end balances but then I need to know what today's are. We advance on a weekly and a daily basis on trade receivables. [Also included in 2(a)] **[TC 2/2, p. 6-7]**

Participant C-7
I guess we rely on historical cost because of consistency and the relative objectivity. I think fair value becomes an issue whenever you think that there's a variance; the degree of variance somehow correlates to your interest in fair values. It's when you see a major variance that you become interested. You want to abandon the historical cost concept, and then get into current value. [Also included in 2(b)] **[TC 2/2, p. 7]**

Participant C-11
I would agree with all of these comments. I think that if we're talking about going concerns, the need for fair value information and its reliability and usefulness, in terms of knowing how well the business is doing, is lot less and definitely that puts it into supplemental status. I think we have a great problem in general as to knowing when a company is in distress, and when we have to take a different accounting approach. So far, all the comments have been focused on revaluing at market values specific types of assets. Nobody's mentioned liabilities. But I think we can't forget that. I want to make a comment that in an increasingly distressed situation, a company doesn't have to, necessarily, sell one particular type of loan or securities or whatever. There is often an option of selling part of its business. And so when you're talking about what is the fair or market value of an entity, it isn't necessarily just individual assets. It can be a business component. And the way you value the component of the company's business is going to be a lot different then. And it may be even more successful a way to take care of a distress situation than just selling its individual loans. I think if you're thinking about market value, you have to think in a more complex way and not just value the specific individual assets and liabilities and think you've done the job. I feel strongly about that. I'd also make just a general comment about supplemental information. I don't ascribe more importance to something because it's in a footnote, as opposed to being in a supplemental schedule of some sort. We have all kinds of supplemental schedules that are required and that's where you can get some of your best data. As a user, I don't have a phobia about needing to have it on the balance sheet or a footnote, per se. [Also included in 2(a), 2(b), and 5(d)] **[TC 2/2, p. 7-8]**

Committee/Staff/Observer
I would just be curious to know if having audited versus not audited financial statements would make a difference in any of your answers? If you didn't have audited statements, those who

would like to see the fair value indicated somewhere, if there was no attestation, does that make a difference? [Also included in 17(a)] **[TC 2/2, p. 8]**

Participant C-17
I'm not going to have some guy (management) come and tell me this is what he thinks his business is worth, without any kind of independent verification. [Also included in 17(a)] **[TC 2/2, p. 8]**

Participant C-13
Wasn't what [participant C-11] was saying run in contrast to that? Because supplementary disclosure are not necessarily verified. [Also included in 17(a)] **[TC 2/2, p. 8]**

Committee/Staff/Observer
I thought that what I was hearing was that [participant C-11] was saying that they would be benchmarked however to some audited statements somewhere. Did I misunderstand? [Also included in 17(a)] **[TC 2/2, p. 8]**

Participant C-11
They could be. In the current data framework that we have, there's certain supplemental data that's just as important as anything in the financials. I think that this is an awkward subject to talk about. But I think that many users don't necessarily have enormous confidence in the integrity of the statements that have been reported on over the past decade. I don't think that I would necessarily say that just because it's audited by a huge firm, it would mean that I would take them at face value. [Also included in 17(a)] **[TC 2/2, p. 9]**

Committee/Staff/Observer
At the bottom of page 4 of the meeting materials, there's a position put on the table that I haven't heard talked about yet. It says that if you used fair value, rather than historical cost, as the measurement basis of financial statements, you might get different measurements of income that might make cuts you don't currently see. The typical example is that inflation will allow companies to look like they're growing because historical cost makes no discrimination about the size of the dollar that's in the balance sheet or the income statement. Where dollar or standard dollar value financial statements or current cost statements or any other varieties that have been proposed over the years would separate out holding (inflation) gains from real gains. So, for example, ABC Company sells 100 widgets every year. And the 5% inflation every year makes it look like the sale of those same 100 widgets is revenue growth. And ABC Company has about the same profit every year. So, from the point of view of what's really happening, ABC Company is really losing against inflation, and perhaps even doing some self liquidating. Is that issue important to you to get an alternative measurement of earnings that somehow makes that cut? And if so, how do we do it, if at all? [Also included in 5(a)] **[TC 2/2, p. 9]**

Participant C-13
In the example you cite, the very first question you ask management about revenues is what's the price impact; that's the simple answer to that question. [Also included in 5(a)] **[TC 2/2, p. 9]**

Committee/Staff/Observer
And you're telling me that is part of what you do? [Also included in 5(a)] **[TC 2/2, p. 9]**

Participant C-13
Yes. You're identifying the price impact on revenues directly for that particular enterprise as opposed to being on a generalized basis. So you're getting to the heart of the problem as it relates to that specific enterprise rise relative to inflation. [Also included in 5(a)] **[TC 2/2, p. 10]**

Committee/Staff/Observer
If you start at the top, then, and you say, okay, I now am going to identify the price per unit effects here, do you do any analysis down from there? And, if so, what? [Also included in 5(a)] **[TC 2/2, p. 10]**

Participant C-13
Let's take a soft drink company such as Coca-Cola. The domestic unit growth is low. But the overseas unit growth continues to be very satisfactory. So, you disaggregate. Then you need to disaggregate the price impacts, domestically and also in major overseas markets. So the next stage is disaggregation of aggregate information. [Also included in 5(a)] **[TC 2/2, p. 10]**

Participant C-4
In construction, all of the contractors typically lock at prices at the beginning of a contract so the gains that occur are on completion of projects. So this information to us is not that crucial. [Also included in 5(a)] **[TC 2/2, p. 10]**

Participant C-2
I think we are accustomed to dealing with these issues of how comfortable we can get with this notion of inflation gains through the analytical process. I think we address the issues. We don't necessarily need to have them screened out for us. [Also included in 5(a)] **[TC 2/2, p. 10]**

Participant C-4
You do run the risk of information overload here, too, at times. You've got to remember that the typical analyst has to get into separating those two elements out. We have some significant borrowers who have been pretty effective in locking in costs by hedging commodity prices or whatever. And that's part of what we would consider operating management. Is that truly manufacturing efficiency that allows you to take that commodity and turn it into a product at a

low cost? Or is it your effectiveness of your hedging strategy such that you lock in early commodity prices? We look at it as one big operating process and the quality of management is all a part of that activity. We're pretty good at analyzing numbers but I could get into information overload if you gave me too much. [Also included in 5(a) and 19] **[TC 2/2, p. 10-11]**

Participant C-2
The point is the cost of determining that in light of that information. And I think for many credit granters we're working with financial statements of small businesses. I think if cost to develop that information becomes more onerous than it presently is, we're going to drive those businesses away from audited financial statements to our detriment. [Also included in 5(a) and 17(a)] **[TC 2/2, p. 11]**

Participant C-17
As lenders, you tend to know customers. So as these issues come up, because of increasing inflation, half the time they're telling you about it or you're asking about it, and whatever. So I think sometimes you can get to the point where it becomes overload. [Also included in 5(a)] **[TC 2/2, p. 11]**

Committee/Staff/Observer
One of the things we're thinking about in terms of the future is: are we heading towards the database or are we heading towards more sophisticated analysis of results? And that's part of the puzzle that we're trying to deal with; on the one hand, we'd like to have both sets of information (fair value and historical cost), on the other hand, that's pretty costly. And if you're not going to use it anyway, why should we provide it? [Also included in 16(a)] **[TC 2/2, p. 11]**

Participant C-17
I think [participant C-2] made a real good point: the small guy, he can't afford it. So you have to balance it. Larger companies tend to be so scrutinized that there are a lot of different sources. It's the little guy who slips in the cracks. And the quality of what you're seeing gets poorer because they simply can't afford it. **[TC 2/2, p. 11]**

Participant C-5
I'll make this comment about the database thinking. The database is a facility that clearly does allow you to make some cuts in data. [Participant C-11] mentioned earlier about all the footnote disclosures. We don't get those footnotes in databases. And so I would hope that even if they are supplemental or footnote type disclosures, that there's at least enough structure that those can continually be databased in such a way that whether it's unrealized gains, they will be included. So there is value to database. I want to say that there is also this individual analysis. And that's where the world is still going to be at. [Also included in 5(d) and 16(a)] **[TC 2/2, p. 11]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of alternative accounting procedures. During the discussion on business combinations, comments were made on value information.

Participant C-4
If you went to mark to market accounting [it could possibly solve problems related to business combinations]. [Also included in 8(b)] **[TC 2/2, p. 42]**

Participant C-11
People are not asking for mark to market accounting now for manufacturing and service companies; only perhaps for financial companies. [Also included in 8(b)] **[TC 2/2, p. 42]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 1

a. At the February 2, 1993 meeting, participants agreed that, as a general rule, they did not support increased use of fair-value-based measurements in the financial statements. Participants offered several reasons for their preferences for current practice and their concerns about recording assets and liabilities at fair values.

Please indicate your agreement or disagreement with each viewpoint below:

SA Strongly Agree
A Agree
N Neutral
D Disagree
SD Strongly Disagree

	SA	A	N	D	SD
Current practice, which is largely based on historical costs, provides a *stable benchmark* from one reporting period to the next, which analysts need to analyze performance.	7	7			

Statement	SA	A	N	D	SD
Estimates of fair value for many assets are *not sufficiently reliable* because of thin or nonexistent markets.	5	7	2		
Estimates of fair value for many assets are *not sufficiently reliable* because management could introduce bias into the estimates of values whenever judgment is required.	5	6	2	1	

Participant C-3: Provide disclosures of discount rates.

Statement	SA	A	N	D	SD
Fair values would result in *unhelpful volatility* or "noise" in the income statement.	3	8	2	1	
Fair value is not *liquidation value.*	11	3			
Fair values of individual assets and liabilities are not as relevant as fair values of *component businesses* when looking at potential sales to improve liquidity.	1	7	3	1	1

Participant C-3: I agree with the statement but the issue is whether fair value is more relevant than historic cost in identifying the impact of potential sales.

Participant C-18: Neither is relevant!

Participant C-2: This depends on size of company.

Statement	SA	A	N	D	SD
Fair values in financial statements would be stale by the time users received the reports containing them.	2	6	4	1	1

Participant C-3: Is historical cost any better?

Statement	SA	A	N	D	SD
Costs to estimate certain fair values exceed the information benefits that users would gain.	1	1			

Participant C-17: Generally, the information is helpful as one of the many measures of capital support (considered) in the effort to determine the need for collateral (should I lend unsecured?) or additional collateral. However, secured lenders will normally look to the value of their assets and will retain independent appraisals to determine same.

Participant C-13: Mixing fair values and historical cost values in the same set of statements is unhelpful and potentially misleading.

Participant C-3: The arguments the committee has made clearly indicate their desire/preference for "reliability" over "relevance." I'm not sure this is right, particularly in an industry where balance sheets have become so liquid!

Participant C-5: Timeliness, accuracy, implied liquidity, and bias already addressed.

Participant C-4: If we are relying on the fair value of underlying assets to extend credit, we would make our own estimates of the fair value using specialists familiar with the market for a particular asset. CPAs don't need to do their own analysis of fair value, leave it to the experts.

Participant C-7: Potential variation in methodologies.

Participant C-14: Fair value information is only relevant to credit analysis for those assets which can be sold to provide liquidity without changing the nature of the company's operation.

Participant C-11: Some data is better as supplemental disclosure or in the management discussion context.

Participant C-15: Lack of ability to make meaningful comparisons due to different valuation methods. Distinguish between financial assets for which there is a secondary market.

b. Some fair value information is already available in financial statements, either disclosed in notes or recorded on the face of the statements (for example, for marketable debt and equity securities). Do you use that information:

5 _ All the time?

Participant C-2: I do use this information in thinking about a <u>range</u> of values for a specific asset or group of assets. Liquidation value (or estimated) establishes the bottom of the range. Other values I might obtain or ponder are: fair, present (DCF), replacement, etc. I then compare those to book value and make appropriate judgments.

8 _ Occasionally, but not always?

_ Rarely?

_ Never?

[PMQC 2/2, p. 1-3]

QUESTION 2

Some participants mentioned that the usefulness of fair value information varies. Listed below are different circumstances that may or may not affect your views about the usefulness of fair value information. Please mark each circumstance U, N, X as defined below:

U The circumstance tends to render fair value information *useful* in my work
N The circumstance tends to render fair value information *not useful* in my work
X The circumstance *has no effect* on my view about the usefulness of fair value information in my work

Participant C-5: Not comfortable with answer choices U, N, X - confusion may impact answers. N- Alternative sources more current and effective.

Type of Asset or Liability
____U-4,N-6,X-2 Receivables
____U-8,N-1,X-3 Inventories
____U-7,N-0,X-4 Other current assets that are financial instruments
____U-0,N-4,X-6,U/X-1 Other current assets that are not financial instruments
____U-7,N-3,X-2 Property, plant and equipment

Participant C-11: Values uncertain.

____U-4,N-3,X-5 Identified intangible assets

Participant C-11: Not as specific numbers, however, I do think about changes in conditions that could produce impairment.

____U-3,N-2,X-7 Purchased goodwill

Participant C-11: Same as above.

____U-10,N-0,X-2 Other long-term assets that are financial instruments
____U-2,N-4,X-5,U/X-1 Other long-term assets that are not financial instruments
____U-3,N-4,X-5 Short-term liabilities
____U-5,N-4,X-4 Long-term debt

Participant C-17: Public debt as a measure of IPO or refinance.

Participant C-11: The term "long term" is misused when applied to a financial intermediary.

____U-1,N-3,X-7 Other long-term liabilities that are not financial instruments, such as deferred taxes
____U-8,N-0,X-3,U/X-1 Off-balance-sheet items, such as forward purchase contracts

Participant C-17: Any adjusted value suspect.

Participant C-11: When related to balance sheet items valued at market.

____ Some other asset or liability (please identify)

____

Participant C-18: Question is not clear. These are not "circumstances," they are b/s categories. Don't know what you are asking here.

Participant C-4: Construction contract entries u/b or o/b.

Intended Usage of the Assets or Liabilities
____U-11,N-2,X-1 Assets held for sale

Participant C-17: Would look to bids or expression of interest by buyers instead.
____U-10,N-0,X-3,U/X-1 Assets held for investment
____U-3,N-5,X-4 Assets used in the business
____U-2,N-8,X-3 Liabilities that will be held to maturity

____U-7,N-1,X-4 Liabilities that will be settled in the near term, perhaps before maturity
____ Some other type of usage (please identify)

____

Degree of Reliability and Source of Fair Value Information
____U-11,N-0,X-2 Quoted market price from active secondary market
____U-5,N-1,X-5,N/X-1 Quoted market price from thin secondary market
____U-10,N-0,X-2 Quoted market price from dealer

Participant C-17: Only if taken from a statistically significant population.

Participant C-11: Can be good or bad data from all sources - no one is better per se.

____U-9,N-0,X-3 Quoted market price from broker

Participant C-17: (same as above)

Participant C-11: (same as above)

____U-9,N-2,X-2 Independent appraisal only

Participant C-11: Not always reliable.

____U-5,N-3,X-4 Management's estimate only (using pricing models, discounting method, or other valuation techniques)

Participant C-3: If it's being used as a "performance system" to compensate management, then why isn't it good enough for financial reporting?

____U-1 Some other source of fair values (please identify)

____

Participant C-2: If values seem reasonable and assumptions are appropriate. Analyst estimates using market approximations gained for general knowledge or publications.

Participant C-4: Our internal analysis.

Company Situation

____U-6,N-1,X-5 Company is a going concern
____U-8,N-2,X-3 Company is in a distressed situation

Participant C-17: Values change about every 5 seconds depending on the perceived leverage of the different parties.

Participant C-2: Best-worst case scenarios.

____U-5,N-2,X-6 Company is in bankruptcy

Participant C-17: (same as above)

____U-10,N-0,X-3 Company will liquidate
____X-1 Some other company situation (please identify)

Participant C-11: Data can be useful, but the kind of data must relate to specific circumstances and can vary from firm to firm.

[PMQC 2/2, p. 3-6]

QUESTION 3

Some advocates point out that fair value financial reporting can estimate the impact of changing price on earnings—distinguishing "holding" gains from "real" gains. Participants did not appear in favor of using fair values for this purpose. The following were suggested as reasons why users do *not* believe fair value reporting is helpful in dealing with changing prices.

Please indicate your agreement or disagreement with each viewpoint below:

SA Strongly Agree
A Agree
N Neutral
D Disagree
SD Strongly Disagree

	SA	A	N	D	SD
Users prefer analysis of *price-volume trends* on revenues as a basis for evaluating the effects of price changes rather than changes in fair value.	4	8	1	1	
Users believe the importance of changing prices is *dependent on the industry and individual company*; it should not be the basis for making a universal change in the basis of measurement.	2	12			
Users *already feel accustomed* to making adjustments in their analyses for changing prices without changing accounting rules.	2	9	2	1	

Users are less concerned with the effects of changing prices on earnings than they are in understanding how companies are *managing finances when changing prices* are important concerns.

SA	A	N	D	SD
3	8	2	1	

[PMQC 2/2, p. 6-7]

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality. During the discussion, comments were made on value information.

Participant C-1

The way you phrased the question, it's an equity question. Because for me, a lot of the write-offs and reserves that are done are more to justify a bad year; let's dump everything we possibly can into it so that our earnings on a net income basis will improve next year whereas from my standpoint cash flow is more important. So I've got to go back and adjust for these reserves that were set up in 1992 for plant closings that are not going to happen till 1993. The other part is that conservatism relates to this concept of hidden assets on the balance sheet where you've got inventories and receivables that are based on cost and maybe should be also based a little bit more on market. Market value might be lower but, at the same time, the market value of fixed assets also based on cost could be dramatically higher. There's no way to really tell whether assets and/or liabilities have any type of reality to the true market value of the company. [Also included in 2(b)] **[TC 3/11, p. 41]**

Committee/Staff/Observer

Let me give you an example that was given to me so I can test your feel for conservatism. Real estate market in Europe is apparently weakening. Realistically, perhaps the collateral is salable now at the value of the loans on the books. However, conservatism might tell you that you believe that the trend will be down. So a very conservative approach would be to project what the real estate market will be three years hence and write the loans that are collateralized down to that level now. Is that appropriate use of conservatism? [Also included in 2(b)] **[TC 3/11, p. 42]**

Participant C-17
No, the move to write the banks' assets down on their performing assets to collateral value would be pretty strenuously objected to. Conservatism may create some real hardships in terms of their ability to lend or their willingness to lend. To just simply do it because it appears to be the most conservative approach is not a good idea. [Also included in 2(b)] **[TC 3/11, p. 42-43]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting. During the discussion, a comment was made on value information.

Participant C-5
I would agree with the core earnings. On the hedging things, knowing on the other side of the world how this operates, the users of the information are not even close enough for your disclosure. We need some increased disclosure but we're ten years, fifteen years from being able to turn it into user-friendly information that the users could understand and really value. The whole issue of what's current value is one thing. The other is what's its sensitivity to future changes and the combination of changes, the volatilities that drive swaps and options. I actually am a little uncomfortable with the accounting profession that views hedge accounting and some of the hedge accounting rules right now. Hedging really operates in aggregate in this concept that you can only, you know, direct match hedging. I just spent two and a half days going through a credit process to approve a whole new set of financial transactions to shift to an accounting focus because we weren't allowed to recognize hedge accounting on something we had done pretty successfully over the last seven or nine months but realizing that we're getting killed on the accounting side of it. I'm still very perturbed with business combination practices and the flexibility that's allowed there. That's either two or three for me. And fair market values, I don't like it from the bank side but I think it's good supplemental disclosure and I wouldn't expect financials to be prepared on that basis. And I mixed that with impairment. To me, impairment is fair market value to some extent. [Also included in 8(b), 15, and 19] **[TC 3/11, p. 71-72]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 8

a. At the January 13, 1993 meeting, participants agreed that, as a general rule, they did not support increased use of fair-value-based measurements in the financial statements relative to current practice. Participants offered several reasons for their preference for current practice

and their concern about recording assets and liabilities at fair values in the financial statements. Those reasons are listed below.

Please indicate for each of the following whether you:

1 Strongly agree
2 Agree
3 Are neutral
4 Disagree
5 Strongly disagree

Rank each item
1 through 5

	Strongly agree	Agree	Are neutral	Disagree	Strongly disagree
Current practice, which is largely based on historical costs, provides a stable benchmark from one reporting period to the next, which analysts need to forecast future performance	*4*	*2*	*1*		
Estimates of fair value for many assets are not sufficiently reliable because the markets for those assets are thin or nonexistent	*5*	*1*	*1*		
Estimates of fair value for many assets are not sufficiently reliable because management could introduce bias into the estimates of values whenever judgment is required	*3*	*4*			
Fair values would result in unhelpful volatility or "noise" in the income statement because historical changes in fair values are often not indicative of the future	*7*				
Fair value is the same as liquidation value, which is not very useful when evaluating the company as a going concern	*3*	*2*	*1*	*1*	
Fair values of individual assets and liabilities are not as relevant as fair values of component businesses when a company may dispose of certain businesses	*2*	*4*			

	Strongly agree	Agree	Are neutral	Disagree	Strongly disagree
Fair values in financial statements would be "stale" by the time users received the reports containing them		*2*	*4*		*1*
Some other reason why investors do not support increased use of fair-value-based measurements in financial statements (please describe) *Participant I-8*: If a company's "value added" is in the manufacture of a product or system from purchased raw materials and components then fluctuations in the fair value of operating real estate or buildings has little relevance.					

b. Some fair value information is already available in financial statements, either disclosed in notes or recorded on the face of the statements (for example, for marketable debt and equity securities). Do you use that information:

All the time? *1*
Occasionally, but not always? *3*
Rarely? *3*
Never?

Participant I-12: In assesssing whether management has pools of assets that could be used to offset negative writedowns.
[PMQI 12/9 and 1/13, p. 12-14]

QUESTION 9

At the January meeting, many participants mentioned that the usefulness of fair value information varies depending on a number of circumstances. The following question explores your views about fair value information in various circumstances.

Listed below are different circumstances that may or may not affect your views about the usefulness of fair value information. Please mark each circumstance 1, 2, 3 as defined below:

1--The circumstance tends to render fair value information more useful in my work
2--The circumstance tends to render fair value information not useful in my work
3--The circumstance does not affect one way or another my view about the usefulness of fair value information in my work

Participant I-12: I think this question is asking whether fair value would be more useful. less useful, or no change in usefulness for various balance sheet line items. Hence, I have used the following scale, which I think approximates the intent of the question for my answers:

1 - fair value accounting would be more useful
2 - fair value accounting would be less useful
3 - fair value accounting would have no meaningful impact.

Type of Asset or Liability	More useful	Not useful	No effect
Receivables	*4*	*1*	*2*
Inventories	*4*	*1*	*2*
Other current assets that are financial instruments	*4*		*3*
Other current assets that are not financial instruments		*2*	*5*
Property, plant and equipment	*1*	*3*	*3*
Intangible assets		*4*	*3*
Goodwill		*4*	*3*
Other long-term assets that are financial instruments	*4*		*2*
Other long-term assets that are not financial instruments		*1*	*5*
Short-term liabilities	*2*	*1*	*3*
Long-term debt	*1*	*2*	*3*
Other long-term liabilities that are not financial instruments, such as deferred taxes		*2*	*4*
Off-balance-sheet items, such as forward purchase contracts	*3*	*2*	*1*
Some other asset or liability (please identify) ___			

Intended Use of the Assets or Liabilities	More useful	Not useful	No effect
Assets held for sale	*5*		*1*
Assets held for investment	*4*		*2*
Assets used in the business	*1*	*2*	*3*
Liabilities that will be held to maturity	*1*	*1*	*3*
Liabilities that will be settled in the near term, perhaps before maturity	*4*		*2*
Some other type of usage (please identify)			

Reliability and Source of Fair Value Information	More useful	Not useful	No effect
Quoted market price from active secondary market	*6*		
Quoted market price fron thin secondary market	*2*	*2*	*2*
Quoted market price from dealer	*3*	*2*	*1*
Quoted market price from broker	*2*	*2*	*2*
Independent appraisal only	*1*	*2*	*3*

Reliability and Source of Fair Value Information	More useful	Not useful	No effect
Management's estimate only (using pricing models, discounting method, or other valuation techniques)	*1*	*3*	*2*
Some other source of fair values (please identify)			

Company Situation	More useful	Not useful	No effect
Company is a going concern	*1*	*3*	*3*
Company is in a distressed situation	*6*	*1*	
Company is in bankruptcy	*6*	*1*	
Company will liquidate	*6*		*1*
Some other company situation (please identify)			

[PMQI 12/9 and 1/13, p. 14-15]

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 21

In a previous meeting, we discussed the advantages and disadvantages of using fair values in financial reporting. One question we did not discuss, but which seems to be important to many advocates of fair value reporting, is the following:

Why do the shares of some publicly-owned companies trade at values substantially less than the book values reported in their balance sheets?

Please consider that question, and based on your own experience, please indicate your agreement or disagreement with the following possible reasons for this disparity.

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
a. Those trading the shares do not believe the accounting rules provide *relevant* values in the balance sheet for the specific company.	2	1			
b. Those trading the shares do believe the accounting rules provide relevant values in the balance sheet, but for the specific company involved, they do not believe the amounts have been correctly reported (they are not credible).		1			1
c. Those trading the shares do believe the accounting rules provide relevant values in the balance sheet and that those values are credible; however, in pricing shares, those traders consider other matters that are not currently reflected in the balance sheet. If you marked SA or A, please identify the "other matters" considered: *Participant I-7:* External structural or competitive landscape. *Participant I-9:* [One company] writes off all advertising expenses and yet surely has a residual value. This understates its book [value]. Similarly, [another company] spends +$1 billion on research and does not project any new drugs, againt making its book too low on a common sense basis. *Participant I-11*: Primarily the expected stream of future earnings or cash flows in a company where (for any of a host of reasons) liquidation is unlikely.	1	1			1

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
d. Those trading the shares are more influenced by the relative attraction of ownership of certain companies or industries than others, and in some cases, the prospects of companies or industries are so poor in comparison to alternatives that trading must be discounted from book values in order to attract buyers.		*3*			
e. Traders do not normally consider the book value on the balance sheet in setting the trading price unless the company intends to liquidate.		*2*			
f. Book values fail to reflect future risks and uncertainties due to economic conditions, management quality, competition, etc., all of which could create a market value below book value.	*1*	*3*			
g. The balance sheet does not reflect certain contingent liabilities which investors consider when valuing shares of a company.	*1*	*2*			

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
h. Something else. Please describe. *Participant I-16:* Accounting is the reporting of transactions according to rules. It is not a measurement of asset values. Conflicts tend to be resolved in favor of income determination. There is no correspondence between economic value and book value. *Participant I-9:* In some companies book is very important in valuing the franchise - i.e. a metals company with a new state of the art plant or a company with net working capital close to its stock price [name deleted]. For most companies, book is not useful for reasons related to write off advertising, research, or technological obselescence. *Participant I-11:* Everyone of these can apply, and it would not be difficult to find examples where each one was the major reason. Basically, though, I think most investors tend to value most companies on a going-concern basis, and to look more at earning power that at asset values.		*1*			

[PMQI 3/17, p. 37-40]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 21

In a previous meeting, we discussed the advantages and disadvantages of using fair values in financial reporting. One question we did not discuss, but which seems to be important to many advocates of fair value reporting is the following:

Why do the shares of some publicly-owned companies trade at values substantially less than the book values reported in their balance sheets?

Please consider that question, and based on your own experience, please indicate your agreement or disagreement with the following possible reasons for this disparity. Respond using the following:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

A-4,N-3,D-6
__ a. Those trading the shares do not believe the accounting rules provide *relevant* values in the balance sheets for the specific company.

SA-1,A-4,N-2,D-6
__ b. Those trading the shares do believe the accounting rules provide relevant values in the balance sheet, but for the specific company involved, they do not believe the amounts have been correctly reported (they are not credible).

SA-3,A-8,N-1,D-1
__ c. Those trading the shares do believe the accounting rules provide relevant values in the balance sheet and that those values are credible, however, in pricing shares, these traders consider other matters that are not currently reflected in the balance sheet.

If you marked SA or A, please identify the "other matters" considered:

Participant C-13: Some companies, because of the nature of their business or their balance sheet, resemble close-end investment companies, and trade at discounts from stated net asset value for the same reasons.

Participant C-14: Not asset values as cost but rather as their ability to produce positive future cash flow.

Participant C-12: (1) Profitability, which reflects a) greater/lesser operating efficiency and b) ability to generate fees, commissions, and trading profits (an intangible). (2) Acquisition potential, may increase the price of a target and may decrease the price of an acquiror (due to fears of dilution).

Participant C-11: This issue relates to non-financial companies that have not addressed impairment - because the standards have not. Also there are times that market can be below book because of considerable uncertainty about the level of earnings or losses.

Participant C-5: Future cash flows.

Participant C-4: The value of the company as a going concern, which includes a multiple of earnings analysis, projected cash flow and market outlook. This information is beyond the role of accountants.

Participant C-21: Future trends in the industry and co's ability to compete effectively; potential management changes, etc.

Participant C-9: Declining issues or industry competitiveness. Economic outlook factors. Anticipated deterioration in asset values. Uncertainty on a competitive matter or litigation.

SA-1,A-7,N-4

__ d. Those trading the shares are more influenced by the relative attraction of ownership of certain companies or industries than others, and in some cases, the prospects of companies or industries are so poor in comparison to alternatives, that trading must be discounted from book values in order to attract buyers.

A-6,N-2,D-4

__ e. Traders do not normally consider the book value on the balance sheet in setting the trading price unless the company intends to liquidate.

SA-5,A-4,N-1,D-2

__ f. Book values fail to reflect future risks and uncertainties due to economic conditions, management quality, competition, etc., all of which could create a market value below book value.

A-10,N-1,D-1

__ g. The balance sheet does not reflect certain contingent liabilities which investors consider when valuing shares of a company.

Participant C-21: Potential litigation.

__ h. Something Else.
Please Describe:
[PMQC 3/11, p. 37-39]

[Background] *The Financial Industry--Banks, Thrifts, Insurance Companies, and Securities Firms* is the second in a series of AIMR Industry Analysis seminars and proceedings. The series was conceived by Charles D. Ellis, CFA, to provide educational material on the nuances of individual industries from the perspective of security analysis. . . . Each seminar is built around an analytical framework that identifies the key factors to consider in conducting an effective analysis of the industry and that highlights the specific interrelationships that underlie sound valuation decisions. . . . The speakers at the seminar, whose presentations this proceedings reproduces in full, are among the leading specialists in financial services industry analysis. **[AIMR FINSER INDUSTRY, p. i]**

[According to Nagle,[1] for banks] the economic value of a balance sheet can be estimated by adjusting each component of the balance sheet to reflect market value rather than accounting value. Determining the appropriate reserves is an important part of this process. With some degree of judgment applied to each financial institution, one can generally apply standards of reserves appropriate for different asset types, and these more accurately portray the financial realities of the company than the picture managements and auditors present. **[AIMR FINSER INDUSTRY, p. 28]**

True economic value is a function of a bank's mark-to-market net worth (liquidation value) plus its projected earnings as a going concern. Going forward, those earnings will be a function of a number of different factors. These include the starting value of the balance sheet; the strategic direction of the company in relation to the evolving role of banking; and the components of income--net interest income on a risk-adjusted basis, operating efficiency, and fee income. **[AIMR FINSER INDUSTRY, p. 28]**

Going-concern value means the extent to which a bank's franchise can generate a return over and above a risk-free rate of return, given its starting marked-to-market net worth. **[AIMR FINSER INDUSTRY, p. 28]**

In discussing whether and how fair value information would be useful in accomplishing their analyses, the analysts drew a clear distinction between fair value accounting on a comprehensive basis and supplemental fair value disclosures. They were almost unanimously opposed to any fair value adjustments that would be reflected in financial statements. Their underlying rationale was that banks are financial intermediaries over an intermediate term. To estimate the fair value of a bank's assets and liabilities, particularly for items that are not

[1] Reid Nagle, President, SNL Securities

traded or held for sale, was seen as ignoring a bank's basic purpose and considered of no value. [Also included in 1(b)] **[KPMG BANK STUDY, p. 38]**

Fair value information was seen by some analysts as being more indicative of liquidation value than of going concern value, and it was noted that a combination of these two issues in the financial statements would result in a confusing and irrelevant product. Several analysts commented that temporary fluctuations in fair value were not particularly important. Others stated that fair value adjustments would not enhance their analyses, confuse existing historical data, and be considered a step backward. [Also included in 1(b)] **[KPMG BANK STUDY, p. 38]**

In contrast, analysts objected less to supplemental disclosures of fair value information, although they were still not overly supportive. Their views ranged from considering fair value disclosures helpful on a supplemental basis to viewing it as information that was interesting but not particularly useful. Others stressed that the subjectivity inherent in estimating fair value renders the information irrelevant and potentially misleading. [Also included in 1(b)] **[KPMG BANK STUDY, p. 38]**

Analysts were concerned about both fair value accounting and fair value disclosures changing bank management's behavior when more attention is focused on fair value information. Specifically, they were concerned that management's focus would change from intermediate- to short-term assets. [Also included in 1(b)] **[KPMG BANK STUDY, p. 38]**

Analysts indicated that if fair value disclosures were to be made, their preference would be to have all financial instruments fair valued. They also indicated that the fair value of intangible assets should be disclosed, specifically citing core deposit premiums. With respect to fair value disclosures for loans, analysts indicated that detailed information underlying the estimates, including methodologies and assumptions, should be provided. They stated that fair value disclosures for loans would be meaningless if these judgmental inputs could not be analyzed. Some preferred receiving the underlying information so they could compute fair value estimates themselves.[Also included in 1(b)] **[KPMG BANK STUDY, p. 38]**

Focus Group Comments, Analysts: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 1(b), 1(c), 2(a), and 2(b)] **[KPMG BANK STUDY, p. 39]**

- Almost unanimously opposed fair value accounting on a comprehensive basis **[KPMG BANK STUDY, p. 39]**
- Moderately supported fair value disclosures; some indicated that such disclosures would be of little use, or even misleading [Also included in 2(a)] **[KPMG BANK STUDY, p. 39]**

- Desired detailed information underlying fair value estimates so they could compute the fair value themselves and compare the results to other institutions [Also included in 1(b) and 1(c)] **[KPMG BANK STUDY, p. 39]**

- Indicated concern over the amount of subjectivity involved in making fair value estimates and questioned the ultimate usefulness of the results [Also included in 2(a) and 2(b)] **[KPMG BANK STUDY, p. 39]**

- Preferred detailed information that would allow them to perform their own calculations [Also included in 1(b) and 1(c)] **[KPMG BANK STUDY, p. 39]**

- Expressed concern that the focus would change to shorter term assets, which they viewed as inconsistent with the basic function of banks **[KPMG BANK STUDY, p. 39]**

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(b), 2(c), 5(a), 5(b), 5(d), and 13] **[KPMG BANK STUDY, p. 39]**

- Preferred historical cost financial statements supplemented with fair value disclosures [Also included in 5(a), 5(b), and 5(c)] **[KPMG BANK STUDY, p. 39]**

- Generally believed fair value disclosures of financial instruments would be useful provided they were reliable and comparable [Also included in 2(b) and 2(c)] **[KPMG BANK STUDY, p. 39]**

- Viewed uniform methodologies, assumptions, and presentation of fair value information as very important [Also included in 5(d)] **[KPMG BANK STUDY, p. 39]**

- Desired precise estimates of fair value **[KPMG BANK STUDY, p. 39]**

- Wanted detailed explanations of methodologies and significant assumptions [Also included in 13] **[KPMG BANK STUDY, p. 39]**

- Believed fair value information would focus asset allocation strategies on shorter term investments [Also included in 13] **[KPMG BANK STUDY, p. 39]**

The quality and usefulness of the information available to the public is an integral part of the analysis of a financial institution's performance and of its estimated value. The questions in this section address the usefulness of the existing financial information and [analysts'] views toward enhancing such information: [Also included in 1(b), 2(a), 2(d), and 15] **[KPMG BANK STUDY, p. A-3]**

- **The Financial Accounting Standards Board (FASB) has recently issued Statement No. 107, "Disclosures about Fair Value of Financial Instruments" which requires additional disclosures of fair value estimates for assets, liabilities and off-balance-sheet financial instruments to be part of the basic financial statements for years ending after December 15, 1992. Indicate the expected usefulness of the fair value disclosures for the following financial instruments.**

	Very Useful	Useful	Not Useful	Not Applicable
Loans	25%	40%	30%	5%
Deposits	25	33	40	2
Long-term debt	15	50	33	2
Financial guarantees	23	38	38	1
Commitments	18	33	45	4
Letters of credit	23	43	33	1
Swaps, options, futures, etc.	33	53	10	4
Other	3	3	3	

[Also included in 1(b)] **[KPMG BANK STUDY, p. A-4]**

- **Although fair value disclosures for the following items are not currently required, indicate if you believe fair value disclosures of these items would be useful in your analysis of an institution.**

	Very Useful	Useful	Not Useful
Core deposit intangibles	18%	48%	34%
Lease receivables	8	53	39
Other			
Goodwill		3	

[Also included in 1(b)] **[KPMG BANK STUDY, p. A-5]**

- **Indicate how time lags in reporting financial information to stockholders and the public will affect the usefulness of fair value disclosures (e.g., the December 31 financial information is not normally issued until the following February or March).**

5% No effect on usefulness
55 Marginally diminish the usefulness
33 Greatly diminish the usefulness
7 No opinion
[Also included in 1(b)] **[KPMG BANK STUDY, p. A-5]**

Indicate the length of time that could reasonably pass between estimating fair values and reporting financial information before the usefulness of the disclosures are marginally diminished.

48% One month
35 Between 2 and 3 months
10 Between 4 and 6 months
3 More than six months
4 No response
[Also included in 1(b)] **[KPMG BANK STUDY, p. A-5]**

Indicate the length of time that could reasonably pass between estimating fair values and reporting financial information before the usefulness of the disclosures are greatly diminished.

10% One month
25 Between 2 and 3 months
40 Between 4 and 6 months
20 More than six months
5 No response
[Also included in 1(b)] **[KPMG BANK STUDY, p. A-5]**

- **Indicate the most useful presentation of fair value disclosures.**

  2% On the face of the financial statements
  37 In various related footnotes to the financial statements
  52 In a single comprehensive note to the financial statements
  9 In the "Management's Discussion and Analysis" section of financial reports
  0 Other
  [KPMG BANK STUDY, p. A-7]

- **Provide any additional comments:**

  Various related footnotes. Does not really matter where the information is disclosed as long as it is available.

  Management's discussion and analysis. Impossible to audit many of these disclosures so they must appear in Management's Discussion and Analysis (footnotes are audited).

  Single comprehensive footnote. This concept is sort of a joke given you are asking management to make the underlying assumptions.

  Management's discussion and analysis. Because of complex valuation issues for both assets and liabilities, the data should be presented along with good descriptive text.

  Various related footnotes. The notion of continuous income statement adjustments and fair value of assets and liabilities is the most dangerous idea I have ever heard.

  Various related footnotes. Adjustments, if ever required, should not flow through the income statement. Nothing should be adopted until liabilities can be adjusted as well as assets.

  Various related footnotes. Managements discussion and analysis related to footnotes can be helpful.
  [KPMG BANK STUDY, p. A-8]

The FASB, the Securities and Exchange Commission (SEC) and other regulatory bodies are currently considering a requirement to prepare financial statements based on market values in place of financial statements prepared on a historical cost accounting basis. The questions in this section relate to this issue: [Also included in 1(b), 2(a), 2(b), 2(c), 10(b), 11(a), and 15] **[KPMG BANK STUDY, p. A-9]**

- **Select one of the following letters that best describes the usefulness of the following financial statement presentations:**

a. Very useful
b. Useful
c. Not useful
d. No opinion/No response

A	B	C	D	
8%	68%	24%		Historical cost without fair value disclosures
70	25	2	3	Historical cost with fair value disclosures
8	18	70	4	Financial statements adjusted to reflect fair value
30	28	42		Two separate financial statement presentations, one based on historical cost and one based on fair value accounting

[Also included in 1(b) and 15] **[KPMG BANK STUDY, p. A-9]**

- **Indicate whether you believe fair value accounting should be the primary accounting basis for the preparation of an institution's financial statements.**

10% Yes
90 No
0 No opinion
[Also included in 2(a), 2(b), 2(c), and 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. The SEC plan takes a portion of assets and no liabilities. While the mix of these factors and the stability of the interest spread are the important elements for financial intermediaries. If fair value is adopted, both sides need to be revalued. Also, fair value accounting would destroy any ability to analyze any asset or liability trends and cash flows. [Also included in 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented]no. [Fair value accounting] would create too much volatility in earnings and, in turn, would impair valuations. [Fair value] disclosure is sufficient. [Also included in 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Market values are too judgmental, I prefer historical cost plus disclosure. [Also included in 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Grave doubts exist as to the usefulness and accuracy of estimates of 'fair value'. [Also included in 2(a), 2(b), and 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Fair market value can be easily manipulated for many financial instruments. In fact, many had commercial real estate loans made based upon 'estimates of market value'. [Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Two formats [are] needed. Fair market value and historical cost [are] required to show reasonableness of prior management decisions. [Also included in 15] **[KPMG BANK STUDY,**
p. A-9]

[One user commented] no. No one is smart enough to place a fair value on an asset or liability for which there is not an active daily market to establish value. [Also included in 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. It is difficult to determine the fair value of many assets and liabilities. This could distort financial statements and hinder comparability. [Also included in 2(b), 2(c), and 15] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Fair value accounting is too judgmental and too susceptible to external factors (i.e., market fluctuations) to serve as the primary accounting basis. [Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. Fair value only would distort the historical trend to management activity. Must have a point (or points) of historical comparison. [Also included in 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. [There is an] inability to accurately adjust values of all asset and liability categories. [Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. Banking is the business of managing credit for intermediate term returns. Fair value accounting does not reflect value added in risk management and creates pressures which will distort the time frame over which credit is managed (i.e., will shift focus from intermediate term to short term). [Also included in 15] **[KPMG BANK STUDY,**
p. A-10]

[One user commented] no. [Fair value estimates] should be handled in notes. [Also included in 15] **[KPMG BANK STUDY, p. A-10]**

- *[One user commented] no.*
  --Misrepresents "lending to maturity" aspect of bank loans.
  --Concern about behavioral impact on bankers.

--Costs more to gather information than benefits users.
--Too much estimation required; comparability and integrity [are] questionable.
--Misuse of information by less-sophisticated users.
[Also included in 2(b), 2(c), and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no.

1) *High degree of subjectivity, and the inherent uncertainty of forecasts on which valuations are based, will diminish both the consistency and comparability of financial institutions' reports.*

[Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-10]**

2) *In loan valuation, changes due to changed assessment of credit risk would be undistinguishable from changes due to interest rate movements.*

[Also included in 15] **[KPMG BANK STUDY, p. A-10]**

3) *Increase potential for accounting abuses.*

[Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-10]**

4) *Certain intangible franchise values would be ignored.*

[Also included in 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. You need both to gain a proper perspective. [Also included in 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. Banks match liabilities and assets to reduce interest rate risk. I don't believe fair value accounting could properly gauge the matching and may force banks into making uneconomic decisions for accounting reasons. [Also included in 15] **[KPMG BANK STUDY,
p. A-10]**

[One user commented] no. Need to understand strategic posture of company with respect to the balance sheet and contingent items to determine whether fair value approach is appropriate. [Also included in 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. Too judgmental once one gets away from liquid and marketable instruments. [Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. Loan and deposit contractual agreements are not normally sold and do not have legitimate secondary markets that permit more than conjectural market value assessment; therefore, to force such assessments is a costly sham! [Also included in 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] yes. Most realistically reflects market value of company's equity - market now guesses at the value - greater disclosure will result in more efficient pricing of stocks. Also, will force management to take into account information from the market -

e.g., declining value of real estate loans might have shut off real estate lending spigot sooner. [Also included in 2(a) and 15] **[KPMG BANK STUDY, p. A-10]**

[One user commented] yes, however, I would qualify my answer by acknowledging that valuation of many loans is subjective. Thus I have serious concerns regarding:

1. *Comparability among more conservative and less conservative banks*
2. *Restrictions in lending/credit crunch involving borrowers which are very difficult to value.*

[Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] yes. But need a transition period with both historical and current provided. [Also included in 15] **[KPMG BANK STUDY, p. A-11]**

- **For each of the categories listed below, select the letter that best describes the manner in which you prefer fair values to be presented in the financial statements:**
  a. Adjustment to income
  b. Adjustment to stockholders' equity
  c. No adjustment, prefer historical cost accounting basis supplemented with fair value disclosures
  d. Do not prefer fair values
  e. No opinion

A	B	C	D	E	
5%	33%	60%	2		Equity investments securities
8	18	72	2		Debt investment securities
5	18	68	8	1	Purchased mortgage servicing rights
10	18	57	13	2	Excess mortgage servicing rights
8	15	45	32		Loans
8	13	55	24		Demand deposits
8	12	52	28		Time deposits
5	15	60	20		Long term debt
5	15	55	23	2	Other borrowings
3	13	50	30	4	Financial guarantees
3	10	53	32	2	Commitments to extend credit
2	13	58	25	2	Letters of credit
5	15	68	8	4	Swaps, options, futures, etc.
	3	3			Other

[Also included in 15] **[KPMG BANK STUDY, p. A-11]**

- **There are current accounting rules that require the disclosure of fair values, realized and unrealized gains and losses, cash flow information and maturities and yields of investment securities. Considering that this information is already available, indicate whether you believe the historical cost based accounting should be replaced with fair value based accounting.**

8%	Yes
88	No
2	No opinion
2	No response

[Also included in 2(a), 2(b), 2(c), and 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. Much of the additional information that would be available with fair value accounting must be based on estimates which are likely to incorporate varying assumptions and therefore, is unlikely to be reliable or consistent. Further, much of what is proposed is irrelevant for valuing a banking company. [Also included in 2(a), 2(b), 2(c), and 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. Fair values may be considered in evaluating an institution's capital adequacy, but should not be the primary factor. [Also included in 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. The principal asset of intermediaries is loans, which don't lend themselves (particularly commercial loans) to fair value accounting due to differences in loan quality. [Also included in 15] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. I would like increased footnote disclosure of fair market calculations. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. If implemented, it would result in undue and unpredictable fluctuation in financial results (earnings and equity) even where the institution has no intention of selling the assets. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Information is subject to too much management judgment. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Fair market value accounting should be supplementary in nature. [It] does not allow [for] reasonable predictions of product performance-loans and mortgages would be confusing if the balance sheet was marked to market. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Historical data has significant value and most importantly provides some comparability enhancement for depreciation, amortization, and many other financial statements items. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. I believe more detailed information as to asset quality would better allow the user to interpret financial statements. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Footnote disclosure [is] largely adequate -- would like for swaps, and hedges also. True fair market for entire balance sheet puts banks into a different business, from long-term investor to broker or short-term investor. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Historical cost should be maintained but disclosure should be broadened. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Volatility in reported numbers could create unnecessary volatility in securities -- potentially disrupting capital raising activities. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Should not be done piecemeal. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Investment securities are only a minor part of most balance sheets. Information relevant to the economic value of the corporation is already disclosed. Marking securities to market on the financial statements would lead to spurious volatility without adding information. Attempting to mark some corresponding subset of liabilities to market adds complexity, but again fails to add valuable information. Further, it would distort existing important information regarding net interest margin. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. The footnote of market values works fine. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Most adjustments would be unreliable approximations of improbable or impossible transactions; they would create destabilizing volatility of earnings that would not fairly reflect realities of going concerns. Lack of timeliness a problem also. [Also included in 2(b) and 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Both give you a more comprehensive picture. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

[One user commented] yes. Provided that liabilities funding investments are similarly adjusted. [Also included in 15] **[KPMG BANK STUDY, p. A-12]**

- **If the FASB requires fair value accounting for certain investment securities, indicate whether you believe it would be useful for certain liabilities to be also recorded at fair value.**

85% Yes
10 No
5 No opinion
0 No response

If yes, indicate which liabilities.

50% Demand deposits
60 Time deposits
70 Long term debt
65 Other borrowings
- Other,
2 Insurance liabilities
13 All liabilities
2 Other
[Also included in 15] **[KPMG BANK STUDY, p. A-13]**

- **For an institution that has the intent and ability to hold assets for the foreseeable future (defined as 12 to 18 months), indicate whether you believe fair value accounting is appropriate.**

30% Yes
60 No
8 No opinion
2 No response
[Also included in 2(b), 2(c), 10(b), and 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Provided there is assurance that assets will be held to maturity, short term market swings would be misleading if fair market value accounting is applied. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Not appropriate, but 12-18 months is too short. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] depends, fair value footnotes would be helpful. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented no.] If institution has the intention of holding the securities through changes in interest rates, then the equity of the organization would not seem to be at risk. Further, in most instances securities portfolios are funded with wholesale liabilities which generally match fund portfolios. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. For many of these investments it is almost impossible to determine the net realizable value. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Foreseeable future defined as 12-18 months seems too short. I would think foreseeable future implies a multi-year holding [period]. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. The crux of bank valuation is the ability to manage risk over an intermediate time frame so day to day market values may be irrelevant. [Also included in 10(b) and 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Ultimately will discourage bank intermediation function if banks are forced to recognize fluctuations in their assets and liabilities. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no opinion. Should not be done piecemeal. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Caveat - must establish way for investment or analyst community, to verify that assets are being held for the stated period. [Also included in 15] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Distorts the precept of a going concern, will distort activities of the firm -shortening the timeframe for decisions (which is already too myopic). Should we mark plant and equipment to market, based on current demand for the output? Nonsense! [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Fair value accounting would not reflect the nature of the true intermediary function banks provide. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. [Fair value accounting is appropriate] provided there is an active market in those assets. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. If interest is to hold to maturity at the present time, regardless of whether future events could change, historical cost is appropriate. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. Some effort at fair accounting is still useful for these organizations. However, if the subjectivity involved is too great for certain loans so that comparability is destroyed, I would favor historical cost with an explanatory footnote. [Also included in 2(b), 2(c), and 15] **[KPMG BANK STUDY, p. A-14**

[One user commented] yes. Intent and ability are subject to change. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. You need both! [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. Use historical [cost accounting and] supplement [it] with fair market values. [This will make the financial statements] easier to use and interpret. [Also included in 15] **[KPMG BANK STUDY,
p. A-14]**

- **Indicate whether you believe fair value accounting will provide a more accurate measure of a financial institution's capital.**

38% Yes
60 No
2 No opinion
[Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Assuming adequate footnotes [provide] market values, where available, as well as asset quality. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Not unless all asset and liability categories are accurately adjusted. [Also included in 15] **[KPMG BANK STUDY,
p. A-14]**

[One user commented] no. The crux of bank valuation is the ability to manage risk over an intermidiate time frame so day to day market values may be irrelevant. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Only where liquidation is imminent. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. [Because fair value accounting would] include unrealized gains/losses [in capital even though they] may never be realized and thus [may never be] part of capital. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Because of difficulty in determining fair value of loan portfolios and [the number of] possible alternatives in assumptions and/or methodologies. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Since foreign institutions would not be covered, [fair value accounting will] present competitive inequities. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Can do with the current footnote disclosure. But this market value accounting puts [a] company into a liquidation mode -- not their function. Would overstate. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Disclose the pieces and allow investors to make their own judgements. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Interest rate and related market fluctuations of a transitory nature will distort the financial realities of the firm. [Also included in 15] **[KPMG BANK STUDY, p. A-14]**

[One user commented] an institution's capital may be more than adequate to fund growth and cover losses over time whereas at any point in time (when interest rates are at extremes) it may be inadequate. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. If done for entire balance sheet. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. Negative trends will be apparent quicker. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. [Fair value accounting] will create huge volatility in price and market value. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. Adjusting the capital account for unrealized gains and losses is something the capital markets already do. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. If fair value is applied only to maturing instruments in any twelve month period. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented yes.] Only if handled correctly. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented yes.] It will provide another view. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

- **Financial institutions generally release their results of operations and financial position two to three weeks after period end. If historical cost accounting was replaced with fair value accounting, it is expected that a financial institution's results of operations and financial position based on fair values would take more time to gather and not be released as soon. Indicate the amount of additional time delay that you would be willing to accept in order to obtain financial statements presented on a fair value basis of accounting.**

58%	Two weeks or less
18	Between 3 and 4 weeks
0	Between 5 and 6 weeks
0	Between 7 and 8 weeks
15	Other
9	No response

[Also included in 11(a) and 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] disclosure of characteristics of assets/liabilities is easier to use, takes less time, and provides more flexibility. Given this information, analyst can mark to market anytime in [a] cycle. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] fair value accounting would make quarterly reports more difficult, but should not affect [the] timing of the annual report. [Also included in 11(a) and 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented I would] prefer to have timely cost data. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] the existing delays are already too long. Further delays would result in fair values that are stale and no longer reflect current market conditions. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] there is no reason why fair value accounting should take longer. Provided the date of fair value was evenly distributed and prominently displayed, it wouldn't have to be after quarter end. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

[One user commented] when a financial institution is late reporting, it means trouble. To add an excuse to delay a report reduces the efficiency of capital markets. [Also included in 15] **[KPMG BANK STUDY, p. A-15]**

One of the objectives of financial reporting is to provide information to analysts, investors, creditors and others that is useful in making investment, credit and other financial decisions. The questions in this section relate to the analysis of financial information and [analysts'] views relating to the importance and usefulness of various financial disclosures: [Also included in 1(b), 1(c), 1(d), and 10(d)] **[KPMG BANK STUDY, p. A-16]**

- **As part of your analysis of an institution, select the letter which best describes the reason for adjusting the following financial instruments to fair value:**
  a. To evaluate the institution's earnings
  b. To evaluate the institution's capital
  c. Combination of a. and b.
  d. No reason to adjust to fair value
  e. No response

A	B	C	D	E	
3%	60%	23%	10%	4	Equity investment securities
10	53	23	13	1	Debt investment securities
13	35	23	25	4	Purchased mortgage serving rights
15	30	20	30	5	Excess mortgage servicing rights
15	30	18	35	2	Loans
5	28	18	45	4	Demand deposits
5	30	20	40	5	Time deposits
5	45	18	30	2	Long term debt
8	38	18	33	3	Financial guarantees
3	35	18	40	4	Commitments to extend credit
3	33	20	40	4	Letters of credit
5	40	25	23	7	Swaps, options, futures, etc.
0	0	0	0	0	Other

[Also included in 1(d)] **[KPMG BANK STUDY, p. A-16]**

- **Indicate the number of consecutive periods of fair value disclosure you would require before fair value information begins to influence your analysis.**

25% Four or less consecutive quarters
33 2 to 3 years

13 3 to 5 years
23 Not anticipated to be used
5 Fair values presently being used and influencing my analysis
1 No response
[KPMG BANK STUDY, p. A-19]

Estimates of fair value may vary by institution because of different assumptions, methodologies and the practicability of such disclosure. The following questions relate to the reliability and comparability of fair value estimates: [Also included in 1(b), 1(c), 1(d), and 2(b)] **[KPMG BANK STUDY, p. A-20]**

- **If fair value estimates for financial instruments were only included in the footnotes to the financial statements, select the letter which best describes the amount of measurement error in fair value estimates you would tolerate before you consider these estimates to be misleading.** ***Measurement error is defined as the variance between the precise fair value and the disclosed estimated fair value:***
  - **a. Within plus or minus 1%**
  - **b. Plus or minus 1 to 5%**
  - **c. Plus or minus 6 to 10%**
  - **d. Plus or minus 11 to 20%**
  - **e. More than 20%**
  - **f. Other**
  - **g. No response**

A	B	C	D	E	F	G	
33%	45%	13%			5%	4%	Equity investment securities
35	53	5			5	2	Debt investment securities
	55	30	5	3	5	2	Purchased mortgage servicing rights
	50	35	5	3	5	2	Excess mortgage servicing rights
10	50	23	3	8	5	1	Loans
18	48	15	3	5	5	6	Demand deposits
20	45	15	3	5	5	7	Time deposits
23	50	10		5	5	7	Long term debt
	53	30	5	3	5	4	Financial guarantees
5	45	25	10	5	5	5	Commitments to extend credit
3	53	28	5	5	5	1	Letters of credit
10	55	18	5	3	5	4	Swaps, options, futures, etc.
	3						Other

[One user commented] that for large categories like loans, a 5% value difference would destroy any sense of trend, and could wipe out equity capital.
[Also included in 2(b)] **[KPMG BANK STUDY, p. A-20]**

- **If fair value estimates were the primary basis used to prepare the balance sheet or statement of operations, select the letter which best describes the amount of measurement error in fair value estimates you would tolerate before you consider these estimates to be misleading. Measurement error is defined as the variance between the precise fair value and the disclosed estimated fair value:**
  - **a. Within plus or minus 1%**
  - **b. Plus or minus 1 to 5%**
  - **c. Plus or minus 6 to 10%**
  - **d. Plus or minus 11 to 20%**
  - **e. More than 20%**
  - **f. Other**

A	B	C	D	F	
58%	25%	5%	3%	9%	Equity investment securities
63	25		3	9	Debt investment securities
40	33	15	3	9	Purchased mortgage servicing rights
40	35	13	3	9	Excess mortgage servicing rights
50	23	15	3	9	Loans
50	30	8	3	9	Demand deposits
55	25	8	3	9	Time deposits
53	30	5	3	9	Long term debt
35	43	8	3	11	Financial guarantees
38	35	13	3	11	Commitments to extend credit
35	40	10	3	12	Letters of credit
48	33	3	3	13	Swaps, options, futures, etc.
	5				Other

[Also included in 2(b)] **[KPMG BANK STUDY, p. A-21]**

- **Indicate the importance of disclosures relating to the following items used by the institution to estimate fair value.**

	Very Important	Important	Not Important	No Response
Specific methodology used to estimate fair value	85%	10%		5
Discount rates	83	13		4
Estimated amount of cash flows	48	45	3	4
Estimated timing of cash flows	48	45	3	4
Other relevant assumptions	43	45	3	9
Source of market prices	58	33	5	4
Sensitivity of fair value estimates to changes in assumptions	68	25	3	4
Other				
Availability of true markets	3			
Changes in assumptions since last published		3		

[Also included in 1(b)] **[KPMG BANK STUDY, p. A-21]**

- **Detailed guidance on how to estimate fair values does not exist. Indicate how important detailed guidance is to the fair value estimation process.**

73% Very important
25 Important
2 Not important
0 No opinion

Provide any additional comments:

Not important. The cookbook approach won't work. Also, loan-by-loan opinions will be used, and are subject to huge variations of value.
[Also included in 1(d)] **[KPMG BANK STUDY, p. A-22]**

- **Indicate the importance of uniform financial statement presentation of fair value information among financial institutions.**

85% Very important
3 Important
8 Not important
4 No opinion
[Also included in 1(c)] **[KPMG BANK STUDY, p. A-22]**

- **Indicate the importance of uniform fair value methodologies and assumptions among financial institutions.**

  90% Very important
  8 Important
  2 Not important
  0 No opinion
  [Also included in 1(c)] **[KPMG BANK STUDY, p. A-22]**

- **Indicate the importance of the consistency from period to period of fair value methodologies and assumptions used by a financial institution.**

  90% Very important
  8 Important
  2 Not important
  0 No opinion
  [Also included in 1(c)] **[KPMG BANK STUDY, p. A-22]**

- **Provide any additional comments:**

  [One user commented] to the extent fair value accounting is adopted, consistency and uniformity over time and across institutions would be essential to maintain credibility. [Also included in 1(c)] **[KPMG BANK STUDY, p. A-22]**

  [One user commented] even if I don't use it, I would have to be aware of how the market would react to certain trends that might get reported [if fair market values were used.] **[KPMG BANK STUDY, p. A-23]**

  [One user commented] fair market value accounting would be useful in footnote disclosure to supplement historical data. I'm more interested in further disclosure of existing historical financial information. [I] don't need fair market value balance sheets and income statements. **[KPMG BANK STUDY, p. A-23]**

  [One user commented] fair market value accounting would confuse analysts if characteristics of assets [are] not presented. **[KPMG BANK STUDY, p. A-23]**

  [One user commented] I am also concerned about the potential effects which fair value accounting might have on managements decisions, especially in view of the rigid capital requirements laid down by FDICIA. By inducing managements to shorten maturities and otherwise avoid assets and liabilities which might fluctuate in value, adoption of a fair

value standard may well result in sub-optimization of earnings opportunities (even on a risk-adjusted basis), thus detracting from shareholder value. **[KPMG BANK STUDY, p. A-23]**

[One user commented] I am not opposed to additional footnote disclosures if these would be meaningful, timely and would not add materially to costs. Primary statements, however, should remain on a historical cost basis as at present, with loan quality being dealt with through the loss reserve. **[KPMG BANK STUDY, p. A-23]**

[One user commented] most of my reservations relate to the degree of judgement that would be required to state fair market value for nontraded instruments -- and how realizable would those estimates be in practice? **[KPMG BANK STUDY, p. A-23]**

[One user commented] market value accounting is another crackpot notion from Ivory Tower people who have never run banks or businesses. It would not only destroy the value of existing financials, it would badly distort management decision-making. We want American business to think long-term, but we want to value their enterprises on today's liquidation basis. It is a major non sequitur. **[KPMG BANK STUDY, p. A-23]**

[One user commented] financial data are correlated to a high degree - the fair market value is reflected to some degree in other financial data - a good analyst can measure the impact, if desired, for example in net interest income especially with existing disclosure - profitability remains the number one concern in analysis - fair market value is a redundancy. **[KPMG BANK STUDY, p. A-23]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

[One analyst] could not see how fair market value accounting could be implemented for real estate entities. The key issue for real estate firms is the tremendous variance in accounting policies towards expensing items versus capitalizing items. He said that earnings per share is a useless number and that cash flow per share is paramount. He defines recurring net income or net funds from operations as net rents minus G&A minus interest. He feels a meaningful ratio is this number (funds from operations) divided by historical costs of all properties. [Also included in 1(b), 1(c), and 5(a)] **[GOLDMAN, p 1]**

Financial statements are imperative for [one analyst] in her work. Her main complaint is that banks should report their revenues and expenses by lines of business (segments). She does not like market value accounting; she feels it will lead to behavioral disadvantages, such as the shortening of the maturities of portfolios. Furthermore, earnings would become far too

volatile. She can read the footnotes to find out what she wants to know about market values. [Also included in 1(b) and 3(c)] **[GOLDMAN, p. 1-2]**

[To one analyst the] most important number is the earnings per share on an operating basis. He looks at the quality of assets for trends but not their specific values. He is not a value investor and does not believe you can implement mark to market across the board. How do you value a loan asset? [Also included in 1(b)] **[GOLDMAN, p. 3]**

From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 1(b), 2(c), 2(d), 3(c) 5(a), 5(c), 6, 8(a), 9, 11(b), 11(c), and 15] **[BETRIOU, p. 1]**

It is likely that the objectives of all accounting data users do not coincide. As far as they are concerned, [foreign] financial analysts essentially need data which reflects the economic reality of entities they examine (groups or companies). Further progress is still required and we have broken this down into . . . categories: [Also included in 1(b), 5(a), 6, 8(a), 9, and 15] **[BETRIOU, p. 3]**

- Undervaluation of asset items. The differences between accounting valuations and the "economic reality" results notably from:

    [1] the "conservative rule", indeed useful to protect creditors, but which plans for immediate entering of potential loss and does not take into account latent gains. [Also included in 1(b), 9, and 15] **[BETRIOU, p. 3]**

    More particularly, the historic cost method does not allow showing the potential revaluation of assets. This data would be necessary for investment securities, because of the development of money market funds: part of the financial products are released only when mutual fund shares are sold, distorting the meaning of net financial expenses. [Also included in 1(b), 9, and 15] **[BETRIOU, p. 3]**

    Data on market values included at least in the appendix would give a more precise view of reality. It could concern in priority current assets (investment securities and raw material notably). [Also included in 1(b), 9, and 15] **[BETRIOU, p. 3]**

    [2] of the too large latitude (allowed by the Fourth Directive) in the determination of provisions which may sometimes be profit. It would be preferable to have stricter allowance criteria. [Also included in 1(b), 9, and 15] **[BETRIOU, p. 3]**

    [3] of the too large liberty to capitalize research and development expenditures which could lead to overestimating profit over a period. [Also included in 1(b), 9, and 15] **[BETRIOU, p. 3]**

[Context] Meeting of the Market Value Discussion Group on April 7, 1993. The meeting was devoted to the topic of value information.

Committee/Staff/Observer
We have prepared and disseminated to you a package of information and there are discussion questions. I would like to begin on page 23. The first one I would like to start with is 1A. We have heard in our meetings with investors and creditors that the current mixed attribute system predominantly based on the historical cost framework provides a benchmark from one reporting period to the next. Do you agree with that statement? **[TMKT 4/7, p. 6]**

Participant F-4
Absolutely. **[TMKT 4/7, p. 6]**

Participant F-1
Yeah. **[TMKT 4/7, p. 6]**

Participant F-3
Yeah, I agree. **[TMKT 4/7, p. 6]**

Committee/Staff/Observer
It is easy to summarize the views on that one. Why do you believe the value based system would or could not provide perhaps a similar but different benchmark from one reporting to the next. **[TMKT 4/7, p. 6]**

Participant F-4
Too much variability in a world of constantly changing prices, interest rates, and economic environments. The variability and the way the numbers jump around makes it very difficult to determine what caused what change. So at least there is some stability in the historical cost and you can place some reliance on that. **[TMKT 4/7, p. 6]**

Committee/Staff/Observer
Is the stability real or is the stability contrary to reality? **[TMKT 4/7, p. 7]**

Participant F-4
To the extent that a corporation lays out cash today we know that there was a cash outflow for whatever purpose for whatever asset. A year from now there is another cash outflow. We analysts are perfectly capable of making any adjustments for inflation/deflation. We can make our own assessments, and we can verify cashflow. I think the more I think about all of this is that this is very important. **[TMKT 4/7, p. 7]**

To be able to have some stable measure rather than having a comparison a year from now of a cash value that changed. If I am building a model and using a value at a particular point in time what ends up happening is that you are going to be reflecting in the formal statements a whole variety of reasons for change that may or may not have anything to do with the underlying economic value of the firm. **[TMKT 4/7, p. 7]**

Participant F-3
I would just maybe turn the question around and say it is the lack of stability or lesser stability of a value based system that is not real. Looking at financial institutions what will change the value of a loan portfolio will be the general value, general level of rates, it will be the basis, it will be the incremental spread that is charged for, say corporate securities, it will be an individual spread on top of that which applies to a particular security. Or currency. It will be a lot of things that move not necessarily together but they all move from time to time and they move frequently. So a number that you get on December 31st might be different, might be quite different, from the number you get a week later or two weeks later and to go to market value or an attempt at market value is fine for a trading firm but not for most institutions. It seems to me that it provides a volatility which is not real. **[TMKT 4/7, p. 7-8]**

Participant F-2
The thing that caught my mind, is that a company generally will make some evaluation of investment alternatives, build a plant at x dollars and then over time that plant goes up in value, it doubles over 10 years and then all of a sudden the numbers you are getting include a much larger depreciation charge. I am not sure that really reflects the kind of return that is being made on the original investment. It distorts the numbers. **[TMKT 4/7, p. 8]**

Committee/Staff/Observer
If the original investment were made not in the physical plant itself but rather in a venture that was a public entity and perhaps it was a joint venture would you get a different answer in terms of how that value should be reflected on a statement of financial position? **[TMKT 4/7, p. 8]**

Participant F-2
Well I can understand the balance sheet impact. My problem is more on the income statement whether it really reflects reality by changing those values. Maybe the value sharply increased a year ago and in the current year it hasn't changed at all but is still at a high value, it is distorting the income statement. **[TMKT 4/7, p. 9]**

Committee/Staff/Observer
What about in the transportation industry, is volatility or stability real? **[TMKT 4/7, p. 9]**

Participant F-5
I think moving to a value based system rather than enhancing any benchmark removes any benchmark because in a world of constantly changing interest rates, changing exchange rates

and so forth, on a year to year or quarter to quarter basis, a value based system you are going to get a constantly changing picture of what a company looks like. I would also agree with his point on the income statement. By throwing some of these value changes through the income statement the changes are not going to be reflective of the company's business as an on going concern. **[TMKT 4/7, p. 9]**

Participant F-4
I can't help but take notes on Thursday of last week [name deleted] was worth $65.00 a share by the close of business on Friday according to the market it was worth $49.00 a share. **[TMKT 4/7, p. 9]**

Committee/Staff/Observer
Because of the [name deleted's logo]. **[TMKT 4/7, p. 9]**

Participant F-4
Because of the [name deleted's logo]. My question is whether the market is appropriately reflecting value changes. If we take that same example and apply it to markets for what used to be known as fixed income instruments and look at it from the perspective of the last couple of decades which included some pretty wild fluctuations which may or may not bear any relationship whatsoever to the going concern value of any given firm it bothers me a lot. **[TMKT 4/7, p. 9-10]**

The market represents the merger point of a whole variety of opinions of market participants. I am not certain that the market is always right. There are enormous distortions in the market and while it may be the best measure we have got it bothers me. **[TMKT 4/7, p. 10]**

Committee/Staff/Observer
We are going to touch on this many times this morning but if the answer seems to focus on the problems with the income statement and with volatility. I know we are going to cover it later but it has got to be brought up immediately. Would your answers change if the balance sheet was adjusted or had some kind of value system but the income statement approach went to a separate statement didn't go through income, went to equity, was amortized over some period, or adjusted for next year's volatility. There have been a lot of aicles written th say the balance should be at fair value but we all agree to get it out of the income statement. **[TMKT 4/7, p. 10-11]**

Participant F-1

I do observe, that this "value issue" is one that academics and accounting professionals are spending a lot more time worrying about than I think most of us are --I have thought quite a bit about this issue in sort of philosophical terms and let me try to express my philosophical approach. I think it may be fairly close with at least some of my colleagues. In some ideal sense it seems to me what we want from the financial statements of your company is a record

of the financial effects of actual economic events and in the simplest terms I suppose you are then talking about cash accounting. But we don't live in a cash accounting world so in a complex world we start making adjustments to those simple cash reports. **[TMKT 4/7, p. 11]**

But I think the standard has to be one that there has to be an awfully good reason to step away from that record of actual historical transactions. That's the continuity, that is the benchmark that we look for in the statements as they now exist which are predominantly historical cost. When you start stepping away from what is actually happened you start getting into, for instance, some of the issues that were raised about [name deleted's] recording of revenues in the article of the Journal this morning. **[TMKT 4/7, p. 11]**

I don't want to get involved in what is or isn't proper in that but I think it illustrates the point I am trying to make. I don't see what value accounting accomplishes. I think it takes us a step or several steps away from that benchmark and I think one of the key elements of the problem is in the very simple fact that nobody means the same thing by value accounting. **[TMKT 4/7, p. 12]**

There are five different definitions for value accounting on page 8. What does this mean? Nothing. Well you can create some intellectual structure but I am saying it doesn't give you anything. **[TMKT 4/7, p. 12]**

Participant F-4
In response to [committee/staff/observer]'s questions all of my comments relate to the balance sheet because that is the heart and soul of a financial company and those numbers not only change daily but each and every day. I was talking to [one company] not too long ago about how something like 20% of their balance sheet turns over in the course of a quarter. I am big on average balance sheets because they help me a great deal. I once had a discussion with [another company] and they told me a 1/3 of their balance sheet turns over daily. So what are we talking about in value accounting? We are talking about a benchmark for the value of assets that fluctuates minute to minute and if you take a snapshot at a point in time it can be highly distortive. **[TMKT 4/7, p. 12-13]**

As long as we have average balances in a financial company and average rates that gives us a smoothing if you will, I think that gives us a lot of information. If we start making value adjustments I think it is just going to be very difficult for us analysts to make any notion of how funds are flowing in and out of those categories. **[TMKT 4/7, p. 13]**

Committee/Staff/Observer
What I hear you telling us is that you want a benchmark from one reporting period to the next. If one were to use value information rather than the mixed attribute system we have now the focus it wouldn't be a benchmark that depicts the operating entity. Is that a fair characterization of what you are telling us? **[TMKT 4/7, p. 13]**

Participant F-1
I think the only time you can absolutely determine a value is when a transaction occurs. Without a transaction who knows what the value is. **[TMKT 4/7, p. 13]**

Committee/Staff/Observer
So you would focus more on relevance, reliability? **[TMKT 4/7, p. 13]**

Participant F-6
In our organization we automatically assume that price is value. The price was 49 and the price is 65 the value is something in between that. We all know that over a period of time these temporary impairments because of reactions to events do have a distorting effect and that is what we are talking about. I am very concerned any time somebody mixes the words price and value. I don't disagree that value is converted back into some measurement that looks like price but it isn't. In fact the whole system of the market would cease to exist if value were always price. I don't know which one is value. I would argue that neither one is value and that the market has figured that out. There is an over reaction and the pendulum will swing and eventually will find a home. **[TMKT 4/7, p. 13-14]**

Participant F-5
I think it is very simple to talk about an example of a security where you have a market and you can use the market clearing price for value but I have a problem with so many other categories in the balance sheet. I have a real problem with to use a phrase, a bunch of green eye shades sitting in a room determining what a value is on PP&E and other categories on the balance sheet. I am much more comfortable and it is much more important to me to know what the cost basis is of these assets for the organization and then I can reach my own conclusions. That is what I am paid to do. I am uncomfortable with changing the balance sheet each reporting period. **[TMKT 4/7, p. 14-15]**

Participant F-4
Value is in the eye of the beholder. [Name deleted] is going to have a different notion of the value of any corporation than I am going to have. Value to me is vastly different than value to a creditor, it is vastly different than value to a hedge fund, and it is vastly different than value to a trader. **[TMKT 4/7, p. 15]**

Committee/Staff/Observer
Some reporting entities today report at market price. My mutual fund, for example, statement shows up and I read it. Are any of you suggesting that I would be better off for an entity whose only assets are marketable securities, with the cost basis of the investments? And if not how do we reconcile why I feel good about fair value basis statements in that case. There must be something about its assets, the nature of its assets, that drives us to say value is relevant there but not elsewhere. What is that thing that is driving us away from value? **[TMKT 4/7, p. 15]**

Participant F-3
Maybe it is just the way they do business. The business is you own the shares just like the business of a brokerage firm. We trade the shares, we own it we sell it. The business of other institutions is converting those assets into cash on a slower basis, on a less certain basis over time. **[TMKT 4/7, p. 15]**

Committee/Staff/Observer
Nature of the user maybe would drive the basis. **[TMKT 4/7, p. 16]**

Participant F-6
The nature of the company. The relevance for a financial company is that all of its assets are in fact marked to market. Therefore it is forcing par value or liquidation value on a given day? All assets and liabilities are assumed to be liquidatable on a given day. **[TMKT 4/7, p. 16]**

When I take that kind of thinking and you translate it to a financial institution I hear a lot of talk about transactions and yet all valuations would assume there is one piece to a transaction. The criteria for hedge accounting or mass transaction accounting is so strict that it is very difficult for anyone to realize that in fact there are 6 pieces to a transaction all different sections of the balance sheet. There is less linkage between two pieces of that portfolio than there are between four other pieces of the balance sheet because of a series of transactions that were linked together and some of them are in aggregate, hedging. **[TMKT 4/7, p. 16]**

The whole concept that I liked about the mutual fund is that everything is mark to market. The problem with the bank is that there are so many estimate type assets on the balance sheet that to go to all market values is too much of a stretch, and to go to only some market values is also creating a predicament. **[TMKT 4/7, p. 16-17]**

Committee/Staff/Observer
So in certain limited circumstances value accounting makes sense and in others it doesn't. **[TMKT 4/7, p. 17]**

Participant F-4
I would just add that in the case of the mutual fund you have 100% of your assets in marketable securities and 100% of the right hand side is owner's equity. I think that that particular structure and nature of the business is vastly different than the nature and structure of a bank or a brokerage firm or even an insurance company and that the definition of a going concern for that mutual fund is somewhat different. **[TMKT 4/7, p. 17]**

Committee/Staff/Observer
Based on what we are hearing the range is perhaps of [committee/staff/observer]'s entity which has all of its assets and liabilities easily subject to mark to market valuation, to perhaps the

other extreme which is a steel mill with nothing other than operating blast furnaces. Those might be your two extremes. **[TMKT 4/7, p. 17]**

Participant F-4
Or an insurance company that has nothing but life insurance. It could be a three year life or a fifty year life. **[TMKT 4/7, p. 17]**

Committee/Staff/Observer
But if we could figure out from those two extremes where you draw the line on that kind of a range maybe we would have an answer that would make some sense. **[TMKT 4/7, p. 17]**

Participant F-2
It sounds to me like you are trying to force it into an either or situation. Either historical cost or fair value. It seems to me some of these institutions are better off with more value information in addition to historical. **[TMKT 4/7, p. 17-18]**

Participant F-6
If I take a bond fund, a long term bond fund, in theory the market value of those assets is all adjusted in the NAV. However, yields do end up being different. There is a big concern from my standpoint, that value changes associated with changes and rates for assets held over a period of time and how they get factored into the equation. **[TMKT 4/7, p. 18]**

If in fact these are truly marked to market then in fact all yields should in fact be yielding me 688, today's price on the 10 year treasury. If everybody has a 10 year average duration they should all be 688 and adjust the NAV. There should be no difference in yield. Yet there are. **[TMKT 4/7, p. 18]**

So just a short distance away from me is something that is a working system in the market place, people are willing to buy and sell out of these bond funds, I do the same myself, and am willing to accept that the yields are brought current in terms of NAV. **[TMKT 4/7, p. 18]**

Committee/Staff/Observer
Let's move to discussion point 1B and there we focus on an issue that has been discussed before. That is reliability or the lack of reliability as it relates to the estimation process associated determining value. The point is for many assets fair value must be estimated because there is no active market. Those estimates lack reliability and provide management with opportunities to manipulate the income statement. Aren't there similar opportunities to manipulate income in the current historical cost model? **[TMKT 4/7, p. 18-19]**

Participant F-4
Yes, but we know what they are. **[TMKT 4/7, p. 19]**

Committee/Staff/Observer
So you'll learn under a new system too. If management were to be required to provide support or if they were required to disclose the basis on which the estimates were made I guess that would help you understand the devil a little bit, would it help you understand the devil enough? **[TMKT 4/7, p. 19]**

Participant F-5
How much would it cost them to provide all that support and what benefit would we get out of it? I think cost is one thing that you have to consider. **[TMKT 4/7, p. 19]**

Participant F-3
As I said, I work with bank credit analysis and I set lines for our CD traders, I have done this at other firms as well. I have had occasion to call a trader and say your line is $25 million you own $35 million of a 1 year CD position. A 1 year CD of a known bank with ratings single A, double A, a well rated institution. A one year, heavily traded type of instrument and I have been told on more than one occasion, not a lot but on more than one occasion, I can't sell it because I would have to take a loss. **[TMKT 4/7, p. 19-20]**

A 1 year piece of paper of a well rated, well known institution can't be sold today at the market price. Market value is a very difficult thing. Another example is a number of banks that have bought into [name deleted] funds and other funds, leverage buyout funds. They indirectly own equity securities and some of those institutions are now on a fair value basis. **[TMKT 4/7, p. 20]**

They can't get at that value. Now that is not a bad piece of information to know, the value of the fund, but if you were to liquidate today you couldn't get that value even in a liquidation sense, it doesn't work. **[TMKT 4/7, p. 20]**

Committee/Staff/Observer
One of the things that has puzzled me because you all indicate that you want the historical information for a benchmark but then you apply your own judgements to come up with values. Value depends so much on how the asset or liability is going to be used. In a going concern business why wouldn't you want to have management's estimate of value, fair value not market value, based on how they intend to use that asset? **[TMKT 4/7, p. 20]**

Most of them don't intend to sell it tomorrow and liquidate, they are going concerns. Take a loan for example, we know that the value of a loan if you want to dispose of it today would be much different then if they planned to hold it and work it out and so forth. Why wouldn't you want management's judgement on what that value is and their disclosure about how they intend to use that asset and realize it? **[TMKT 4/7, p. 20-21]**

Participant F-3
Because I think that would introduce additional error. I think if you went back five years and talked to management at [name deleted] they would have said that their real estate portfolio had a market value in excess of the carrying value. It was very high quality and they were getting terrific yields. They were wrong. It introduces an additional element of judgment. I have got to make my own judgements of what the real value is. **[TMKT 4/7, p. 21]**

Participant F-6
As long as there is not a presentation in the actual financials but supplemental disclosure it gives me a sense of what management is thinking. I can tell a lot about people I want to do business with based on how they view value. The model or the suggestion I think is most often discussed, is retaining historical cost with supplemental market value or value disclosures. Supporting documentation of the estimates is provided so that we can make our own adjustments. **[TMKT 4/7, p. 21]**

Participant F-4
How can I verify management's intention of three years ago if I am building an earnings model? I would feel far more comfortable looking at a cash outlay or something that at least I could semi verify and I don't think an opinion or an estimate is verifiable. **[TMKT 4/7, p. 22]**

Committee/Staff/Observer
But a reserve for a loan loss is much the same thing. **[TMKT 4/7, p. 22]**

Participant F-4
Yes, but we know what the original value is because loans are shown at cost and then the loss reserve is deducted. Three years ago banks didn't have enough reserves, today banks have too much reserves. What has happened is the stock market has made a determination in the valuation as to how they feel about the reserve policy and it seems to me that is appropriate. We get to second guess management but I am not so sure that it would be appropriate for management to prepare financial statements based on management's opinion. **[TMKT 4/7, p. 22]**

Participant F-2
I would like to see the information and you have to recognize that it certainly is subject to error. I don't think there is more than a handful of banks that if they have valued their loan portfolio five years ago the values would have proved to have been correct. That is a given but I think it would be helpful to have that their assessment and you can make your own assessment. I don't know if you would place a lot of reliance on it but I think it would be helpful. **[TMKT 4/7, p. 22-23]**

Participant F-4
What additional value would we get from a formal statement by management of their estimates compared to what we get now via presentations, management interviews and newsletters. **[TMKT 4/7, p. 23]**

Participant F-6
I was not asking for a formal statement. The important items are the assumptions. Such as the tenancy on investment property and the lease rollovers and the rates of the average tenancy. All of those statistics which, as you create a uniform presentation will become more consistent. As the standard of information becomes stronger, you will find more consistent valuations. **[TMKT 4/7, p. 23]**

You won't have these rapid swings in real estate where people are irrationally investing in real estate and not understanding the underlying fundamentals. **[TMKT 4/7, p. 23]**

The side benefit for me as a bank credit person is that hopefully value understanding will go up the curve with all this structure to the information and there is some consistency to it. I can gather information, but I can tell you that we have talked to management and the information to support those assumptions isn't there because they haven't pursued it. **[TMKT 4/7, p. 23]**

So the discipline of having it in routine reporting is very important to me and then the issue comes down to cost. I do believe it is costly for them not to do it because they make bad investment decisions. I think the cost of preparation, as long as we don't set too high a standard of excellence, or we don't require too much auditor certification, it will become a starting point for everybody's analysis. **[TMKT 4/7, p. 23-24]**

Committee/Staff/Observer
Am I getting the right sense that the group thinks that because of the reliability of the information is somewhat suspect preference would be to obtain the information on some sort of an overview basis as supplemental disclosure and you could do with it what you want it recognizing that the reliability may not be as crisp as you like it? **[TMKT 4/7, p. 24]**

Participant F-6
Think as to the issue of auditor certification or verification as to the integrity of that data, we want you to verify discounting cap rates used. Any publicly available or more general market information, I would rather deal with myself. What I need to make sure is when they tell me they have leases with no rollover commitments until 1995 that it is a verifiable event, that somebody has reviewed that documentation on the underlying investment asset and that is fact. **[TMKT 4/7, p. 24]**

Participant F-3
If it is presented as supplemental information to help me not misuse it I need a lot of the background on assumptions. I need the underlying rate structure for fixed income securities.

I need the underlying rate structure, I need the spread, I may need information on particular types of loans like nonperforming loans. I think one of the points [participant F-4] alluded to earlier is that it makes a difference how much of something I own. If I own 1/10 of 1% well I can probably pick up the Journal and use that value. If I own 10% maybe it costs me something to get out. If I own 50% maybe I could get a premium selling it to someone else. **[TMKT 4/7, p. 24-25]**

Committee/Staff/Observer
Keeping with the point made earlier, one can't ignore cost benefit issues when evaluating disclosures and additional information in order to make it useable. With respect to the third issue (1C), that is fair values would introduce unnecessary volatility or noise in the income statement because they are not indicative of future market conditions. I think we have already wrestled with that issue and unless somebody has some additional observations that they would like to make I propose we move on to 1D. We have heard that fair value equates to liquidation value and going concern values are more relevant to investors. What are some of the specific reasons why you believe fair value does not represent going concern value? **[TMKT 4/7, p. 25-26]**

Participant F-4
Well I come back to [name deleted] example. If you present the statements as of last Friday on a fair value basis assuming of course one can get reasonable information to value all assets and all liabilities, [name deleted] would be worth 25% less on Friday than it was on Thursday. My argument would be that they are still selling cigarettes, they are still selling their food products, that they are getting cash in, that there is cash going out, that there is a whole variety of continuing aspects of their business. The market can make determinations based on a whole lot of factors and values that are personal to the individual players that may not truly in an economic sense reflect the true value of the firm. **[TMKT 4/7, p. 26]**

Committee/Staff/Observer
Any other thoughts on liquidation value versus going concern value? **[TMKT 4/7, p. 26]**

Participant F-3
There are a couple things. I am not sure that fair value does equate to liquidation value coming back again to the example of the bank that owns part of a private fund, you can't liquidate that. **[TMKT 4/7, p. 26-27]**

Committee/Staff/Observer
It is interesting to me that you haven't mentioned the focus that I think you have on the future earning power of the entity and how that is important in determining an investment decision or a credit decision. That determination may be without regard to fair value or liquidation value and that is what drives the interest in going concern. **[TMKT 4/7, p. 27]**

Participant F-1
I think the [name deleted] example is a beautiful example of that because of what happened on Friday. People reassessed the future earnings and cash flow streams of the company in light of a change not in any asset but in its marketing strategy. The assets are all exactly the same on Friday as they were on Thursday. **[TMKT 4/7, p. 27]**

Participant F-6
But on Wednesday the future profitability was in fact different. **[TMKT 4/7, p. 27]**

Participant F-1
It is just that investors weren't smart enough to recognize it. **[TMKT 4/7, p. 27]**

Participant F-4
But we don't know that future earnings power has disappeared. We don't know that for a fact. **[TMKT 4/7, p. 27]**

Committee/Staff/Observer
If the company were to disclose values based on some discounted cash flow of future earnings I guess people would probably be waiting with some interest for their disclosure in their first quarter report. **[TMKT 4/7, p. 27-28]**

Participant F-4
The company would claim that they are going to make it up in volume but we don't know that. These are all indeterminable facts or indeterminable opinions. **[TMKT 4/7, p. 28]**

Participant F-5
You will still get differing conclusions of value. It is one thing to do a discounted cash flow of a bond where you know for sure what the dollar amounts of the cash flows are. But in a going concern, like [name deleted], if there are 20 people in the room we are probably going to get 20 different estimates of what the annual cash flows are going to be from their tobacco business over the next 10 years. I still don't think you can arrive at what I would term a fair value. I mean we keep using this term fair value but the implication is that it you really have to try to arrive at market value, and I am not sure fair value is market value. **[TMKT 4/7, p. 28]**

Committee/Staff/Observer
What you are saying, [participant F-5], is that we would like to have fair value but we don't have a reliable way of getting it. **[TMKT 4/7, p. 28]**

Participant F-4
But we already have fair value in the marketable securities section of the footnotes. **[TMKT 4/7, p. 28]**

Participant F-6
I think that is market price -- I would still argue I want to know management's strategy as it relates to the asset and when they view value as different than price. The whole analyst community makes a whole living off of target pricing based on assumptions of value and identifying where that is different than price. **[TMKT 4/7, p. 28-29]**

Committee/Staff/Observer
But what about [name deleted], the value of [their] fleet of aircraft, I would expect you to be interested in that wouldn't you? **[TMKT 4/7, p. 29]**

Participant F-1
What does it mean when we say value? I will go back to my philosophical statement at the onset. This notion of value sounds real nifty until you start thinking about it. Value for one person isn't necessarily the same as value for another. I will go even farther value for one person isn't necessarily the same today as it was yesterday. **[TMKT 4/7, p. 29]**

Participant F-6
Even for the same person there are ten different values. Business value is not market value it is replacement value, it is alternative value. You can go through the appraisal institute and they all come back and they think there is one value and we got it. **[TMKT 4/7, p. 29]**

Committee/Staff/Observer
But what if we said for financial reporting purposes, that for assets that are being used in the business the methodology for determining fair value is discounted future cash flows. What if we just set that as the standard so that everyone knew the method. **[TMKT 4/7, p. 29-30]**

Participant F-6
If the discounted future cash flows worked out to be for this main facility to be a million dollars, somebody out there might come in and retool the factory and because of the length of the facility or its size it now has a value of a million five. I can go out in the market place and sell it for a million two. The whole concept is if my DCF value of this is a million and I can sell it for a million two I am out of this business. Give it to someone who can more profitably use the space. It is a higher and better use of that facility. To give me a value of a million dollars as DCF is not right, to give me a value of a million five, which is its value is not right. **[TMKT 4/7, p. 30]**

Committee/Staff/Observer
Isn't it right with the disclosure that the intent of management is to continue to run this factory? **[TMKT 4/7, p. 30]**

Participant F-6
Despite the economics of it, it is important to me that they are going to make an economically improper decision. **[TMKT 4/7, p. 30]**

Committee/Staff/Observer
On the other hand if management changes its mind and says we are going to sell this factory it is no longer a going concern asset, then it seems to me you look and can come up with a million two. **[TMKT 4/7, p. 30]**

Participant F-4
Then we know what the potential gain or loss is because we know what the historical cost is and we can make our own estimate of what potential price might be. **[TMKT 4/7, p. 31]**

Participant F-3
Again I think it can be useful information. **[TMKT 4/7, p. 31]**

Participant F-4
I would argue on the LDC loans that the discounted cash flow with [Company A] was vastly different than the discounted cash flow for [Company B]. If I'm looking at [Company A] and [Company B] at any given point in time there is a huge lack of comparability if you use discounted cash flows. Maybe if [Company A] had done a discounted cash flow assuming five years of no payments and then something at a lower rate and a big recovery at the end, that would have been a proper reflection of what actually happened. The problem is that [Company A] couldn't predict any better than [Company B] could and they both made different business decisions about the exact same loan for different reasons. If you reflect discounted cash flows in the formal statement you will get an awful lot of noise. **[TMKT 4/7, p. 31]**

Committee/Staff/Observer
I think we have covered 1E. Question 1E, "There are mixed feelings about the issuance of fair value information if it were provided in addition to historical cost based measurements currently reported by companies." Unless somebody else wants to make a comment on that discussion point let's move to 1F. **[TMKT 4/7, p. 31-32]**

Question 1F. "Value information was considered to be generally more useful or relevant for financial services companies than for manufacturing companies." **[TMKT 4/7, p. 32]**

Participant F-6
I guess if I were to feel fairly represented here, we have to come back to this concept of one value. I would feel that a bullet point out of all these discussions should say there are more than one value and that the accounting profession has to start learning to deal with the concept of more than value, multiple definitions of value and then assigning appropriate places to use those values. **[TMKT 4/7, p. 32]**

Committee/Staff/Observer
We have heard that loud and clear. We were wrestling with that in our New Model Subcommittee and whether we could define value. **[TMKT 4/7, p. 32]**

Committee/Staff/Observer
You said that we all agree there is a variety of ways to determine value. Then as an add on I think I heard you say that you want to have the accounting profession recognize that and we agree. I think the third point was that you should have a prescribed method in certain cases. **[TMKT 4/7, p. 32]**
Participant F-6
I would agree that there is no one definition of value. There should be definition as to what it is and how it is calculated, and when you use it. **[TMKT 4/7, p. 32-33]**

Committee/Staff/Observer
That is the point I want to focus on. When you say when to use it do you mean for certain types of assets? Do you mean for certain types of companies? **[TMKT 4/7, p. 33]**

Participant F-6
It is a combination of the company scenario, the size of its holding, it is complicated. **[TMKT 4/7, p. 33]**

Committee/Staff/Observer
It could even be the user of financial statements. **[TMKT 4/7, p. 33]**

Participant F-6
Right. The user may make their own determination. Because the accounting profession does not know who the user is, I believe you always have to assume that it is any user. You have to agree that the basic starting point is the type of asset, and the significance of the position and the company's ability to hold the asset to maturity. **[TMKT 4/7, p. 33]**

Committee/Staff/Observer
Let's move to 1F for just a few minutes and that deals with value information and its usefulness comparing financial institutions to manufacturing companies. We have heard that value information was considered to be generally more useful or relevant for financial services companies than manufacturing companies. Do you agree with that? **[TMKT 4/7, p. 33]**

Participant F-2
I guess I would because it is basically because assets turn much more quickly in a financial institution than manufacturers. Manufacturers aren't out replacing their plant every year. **[TMKT 4/7, p. 33-34]**

Committee/Staff/Observer
Any other observations? **[TMKT 4/7, p. 34]**

Participant F-6
Yes, they do turn more frequently or they can be turned in the interim but the relatively shorter maturity of those assets does allow a lot of them to come back to par. There are two kinds of value changes. One is time value changes and how that affects the income statement. Market rates have dropped so therefore the discount rate has dropped. **[TMKT 4/7, p. 34]**

We have a hold to maturity scenario for a year a year and a half. Every one of these presentations suggests a change in the asset value yet I will continue to accrue it at my previous rate of income on that asset when in effect as soon as I go to a mark to market every asset in the market for that maturity spectrum accrues at the same rate of interest. A combination of cash interest as well as either an increase in the discount or amortization of premium. That has not been reflected, and I think that is a reflection that I have from being in financial institutions. **[TMKT 4/7, p. 34]**

Committee/Staff/Observer
Did you agree with the idea that value information would be more useful for a financial institution than for manufacturing? **[TMKT 4/7, p. 34]**

Participant F-6
There is a hidden statement in there that goes a lot further than that and I get concerned about that. If it could be ever limited to that short degree of text I could accept it. **[TMKT 4/7, p. 35]**

Participant F-4
Going through the examples last night, I think if I were an analyst of industrial companies I would get very perturbed at having to revalue the plant and equipment every quarter. But on the other hand it occurred to me that industrial companies seem to be increasingly using technology that has a high degree of obsolescence, involves a lot of additional costs every quarter and perhaps the nature of manufacturing in this country and worldwide and we might be misleading ourselves to think that value information is less important. It could be equally as important for manufacturing companies and perhaps more so especially if we are in an era of inflation or some would argue today deflation. **[TMKT 4/7, p. 35]**

Participant F-3
I have a hard time just thinking about this question because I analyze exclusively financial institutions. It seems to me it is an attractive idea because, not being a manufacturing company analyst, I can see where those values can be a lot fuzzier. On the other hand the value of a commercial loan portfolio is going to be somewhat fuzzy. **[TMKT 4/7, p. 35]**

The value of a core deposit portfolio is going to be fairly fuzzy and even though we could all agree we wouldn't be off by a lot looking at an appropriate discount rate, we are applying it to a huge amount of assets at an institution that is leveraged 20 to 1. So having a fairly minor difference of opinion is going to change my capital ratio substantially. I think it is attractive to

think of most of the financial companies assets as more certain but they are not that certain and it makes a big difference. **[TMKT 4/7, p. 36]**

Committee/Staff/Observer
I guess I am getting back to a point that [participant F-6] made earlier. What is it that gives value to manufacturing entities assets? Is it the operation of those assets? **[TMKT 4/7, p. 36]**

Participant F-6
The assets have a value unto themselves which may be maximized in the operation. But very often they can be inefficient or ineffective. Their value to an alternative user is much more significant and I don't think you can ignore it. It troubles me when manufacturers continue to produce as opposed to making the ultimate buy, sell, hold decision. **[TMKT 4/7, p. 36]**

Committee/Staff/Observer
Doesn't historical cost accounting in that circumstance perpetuate this inefficient use of that asset? **[TMKT 4/7, p. 36]**

Participant F-6
It does. I guess the issue is this big leap to market value or to value. I don't dislike it as I said earlier with disclosure and the analysis it forces people to understand value more. I have said in the past that accountants are changing the economies and they have just about got there but every time they do the financial and economic community moves a little further and you never will catch them. So you are really just trying to keep score. **[TMKT 4/7, p. 36-37]**

Economists have never tried to say there is one value. They realize there are curves going back forth and it is all the intersections that are important. You are trying to find the one curve. The going concern value is important but it may not be the right value and in fact it could just perpetuate a bad decision to continue to operate a plant. **[TMKT 4/7, p. 37]**

Participant F-1
Historical value can lead to that sort of thing but I think of the U.S. steel industry in the late 50's and early 60's with all these marvelous open hearth furnaces. They couldn't afford to retire them because they had too much invested and we all know what happens when technology changes, and technology has been changing in manufacturing for a long time. What was the fair value of those furnaces at that time? Was it based on the expected future cash flows? I mean that is probably how you would have arrived at it based on what the market price for steel was at that time. You would have said those were very valuable properties and in fact they weren't. I keep coming back to this and I hate to sound like a broken record but I think that having a reasonably consistent record of economic events, the historical financial statements provide gives us all a launching point in the financial arena with marketable securities. **[TMKT 4/7, p. 37-38]**

It gets maybe a little iffy. I will defer to my colleagues to understand those things. I would point out that market price that appears in Wall Street Journal is to the nearest 1/8 or 1/16 or 1/32 of a dollar and we think that is really that value of that stock at the close yesterday. Well let's hope that [name deleted] didn't decide to dump their holdings this morning. So even that number is a pretty fuzzy one. **[TMKT 4/7, p. 38]**

Committee/Staff/Observer
If we take that opportunity to move to the next item which is 1G. Question 1G. Fair value information currently reported or disclosed in the financial statements is used by investors and creditors in their analyses. That focuses on value information that is currently reported, whether you use it, the value information that is reported and if so how do you use it? **[TMKT 4/7, p. 38]**

Participant F-1
As you might have figured I don't make much use of it. Because I don't trust it. **[TMKT 4/7, p. 38-39]**

Committee/Staff/Observer
I would like to get a reaction from each of you to this particular question. **[TMKT 4/7, p. 39]**

Participant F-2
All the numbers leave you is historical cost numbers. **[TMKT 4/7, p. 39]**

Committee/Staff/Observer
So you don't use the value information that is currently disclosed in financial statements? **[TMKT 4/7, p. 39]**

Participant F-2
Well I am just now getting more play but to date we haven't used it, no. **[TMKT 4/7, p. 39]**

Participant F-3
Actually I would say that on a footnote basis I do use them. Right now, well for a long time I have been getting the market value of a banks investment portfolio. It is interesting information. If I see that the market value is way below the carrying value that tells me that I need to think about the asset liability mismatch or a possible mismatch. If I see that the market value is higher, even though I sit here and say gee market value is a very fuzzy concept, I know that there is cushion there that the company has available for certain types of expenses. **[TMKT 4/7, p. 39]**

Committee/Staff/Observer
Or income recognition. **[TMKT 4/7, p. 39]**

Participant F-3
They can offset a loss somewhere else. One thing I did preparing for this meeting, I had someone run numbers on the 20 largest banking companies and we took the market to book ratio from the American Banker last week and then we took the new footnote on fair value. We took the excess of the fair value of assets over carrying value, netted out the excess liabilities and then compared that to equity and we looked for a correlation between the excess fair value to equity and the market to book number and didn't see much of a correlation. **[TMKT 4/7, p. 39-40]**

I got an r squared of 19%. It is not zero in one direction or the other. On the other hand there were six of these companies with a market to book over two, that is [names deleted]. Two of those, [names deleted] have the highest amount of excess fair value relative to their common equity. On the other hand two others, [names deleted] are at the low end. The equity market just doesn't seem to correlate to the fair value numbers. **[TMKT 4/7, p. 40]**

I would also suggest that this tells you there are problems with those numbers because [name deleted] has the highest net interest margin in the business and if the difference between what you see on assets and pay out on liabilities is the highest in the business it seems to me intuitatively that there ought to be a lot of excess value either in the assets or in the liabilities and they are saying no there isn't. **[TMKT 4/7, p. 40-41]**

Committee/Staff/Observer
I guess that I wouldn't have expected the correlation between the aggregate market value, stock value of a bank and the fair value of the disclosures under 107 to correlate because 107 doesn't give any recognition to enterprise value, to core deposit intangibles or the customer base. **[TMKT 4/7, p. 41]**

I think that if financial reporting went to a full fair value basis up and down both sides of the balance sheet it would only be of coincidence if it came out equal to the aggregate stock value of the company. The individual assets and liabilities would not be giving recognition, at least under the current accounting approach, to the intangibles that exist in probably every successful company and which are reflected in the stock price. **[TMKT 4/7, p. 41]**

Committee/Staff/Observer
Could you summarize what you learned from the exercise in a sentence or two, and was it worth while? Is it something you are going to have your people do every quarter or every year? **[TMKT 4/7, p. 41]**

Participant F-3
For the time being I am going to push it to see if I can find other things that will help lift this. **[TMKT 4/7, p. 41]**

Committee/Staff/Observer
I would just like to pursue the point I think we have kind of heard that generally that people do earning forecasts in order to help them reach a decision on whether or not it is a good or bad investment. In terms of credit rating agencies, do they do something that is similar in most respects except maybe bit more focused on cash flow? **[TMKT 4/7, p. 42]**

When you went through that process of looking at value does that in any way affect your earnings forecast? I mean do you go back and look at your earning forecast and say well I need to reduce that because there is some probability that the bank or whatever entity may lose some money as a result of selling off a part of its portfolio? Do you just ignore it, is it simply a "gut feel" process? **[TMKT 4/7, p. 42]**

When you go through the footnotes what do you do with the information? **[TMKT 4/7, p. 42]**

Participant F-5
Well I think the usefulness of the value information is a direct function of whether or not I know what the intent is of that asset. I mean for example a securities firm with a trading portfolio obviously it is useful to know the market value versus cost for the portfolio. But a bank which has some 2 year CD's that they intend to hold to maturity, is it useful for me to mark those to market as interest rates move? **[TMKT 4/7, p. 42-43]**

I don't really think it is for really two reasons. Number one presumably the loans made with the funds they got from the CD's at the time they issued them were priced at the rate at that time. Both of those are going to have a certain maturity and secondly movements in rates, are going to be reflected in the income statement in higher interest costs vis a vis interest income. It will already be reflected in the net interest income due to the nature of their business. **[TMKT 4/7, p. 43]**

I think the relevance of the information on value really is a function of do I know the intent of what you are going to do with the asset. **[TMKT 4/7, p. 43]**

Committee/Staff/Observer
To go back to your example the loans at market and the deposits at market, and the current costs of bonds. Wouldn't that give you a sense as to whether or not they have matched their assets and liabilities like you so described? **[TMKT 4/7, p. 43]**

Participant F-5
Well I think it would be reflected already in the income statement. I mean if you have got a lot of high cost CD's relative to existing rates, you are going to see a withering net interest income line over time. Why would I want to mark it to market on the balance sheet? How would that be useful to me? **[TMKT 4/7, p. 43]**

Committee/Staff/Observer
Is it fair that to say then that you typically don't use the fair value disclosures that are included in financial reporting? **[TMKT 4/7, p. 43-44]**

Participant F-5
I use them for a securities portfolio that is a trading portfolio, not for securities that will be held to maturity. **[TMKT 4/7, p. 44]**

Participant F-3
Here is an example, a few years ago [name deleted] system acquired a three billion dollar long treasury portfolio which they funded with very short term liability and they did so at a time when rates started to rise. At one point the mark to market loss on that portfolio was around 500 to 550 million dollars. The way that I could use that information was to say these guys are trapped because that was about half of their net worth. **[TMKT 4/7, p. 44]**

If they cannot get out of this position, they can't afford to sell that portfolio right now, so it was useful information. At the same time I think there were people who looked at that number and said, they are dead. If that number gets to be a billion dollars, they are out of capital and they are gone. I think maybe there was some additional concern in the market place that even though it would have taken years and years to realize that loss because they intended to hold the securities the market was looking at that loss number compared to their net worth and at zero everyone would have backed away. A liquidity crisis would have caused that institution to fail. **[TMKT 4/7, p. 44-45]**

Committee/Staff/Observer
[Participant F-6], how do you use fair value information that is included in current financial reports? **[TMKT 4/7, p. 45]**

Participant F-6
We use it and we make some modified calculations. We typically do an adjusted capital calculation which takes into account market value appreciation/depreciation. It also assumes a normal level of reserves based on the level of NPA's. It tries to normalize out a distorted reserve which is becoming common among the financial institutions. I will tell you that because of the way it is done and the way it is disclosed we are dealing with it in isolated sections like capital versus assets. I haven't looked at the earnings implications. **[TMKT 4/7, p. 45]**

Committee/Staff/Observer
So you don't run that through? **[TMKT 4/7, p. 45]**

Participant F-6
It is not an integrated financial analysis. We look at select components principally, value on balance sheet type things and leverage. It is not income statement focused. We never do it in an integrated fashion. It is more of an individual snapshot. **[TMKT 4/7, p. 45]**

Committee/Staff/Observer
Do you see yourself evolving to a more integrated approach as people become more comfortable and more familiar with the disclosures that are now included in financial reporting? **[TMKT 4/7, p. 45-46]**

Participant F-6
In commercial companies we do a lot of projecting, but because of the annuity nature of financial companies we don't do actually a lot of forward projection. For any commercial entity that has a term asset loan over a year or revolver, we would require ourselves to get management's projections and then do our own base case analysis because of the volatility. I look at a lot more quarter to quarter analysis in manufacturing companies. In financial institutions I have been pushing the idea of quarter to quarter analysis but we don't do it. We really do a lot of year to date analysis because of the annuity nature of the business. **[TMKT 4/7, p. 46]**

Committee/Staff/Observer
[Participant F-4], how do you use fair value information? **[TMKT 4/7, p. 46]**

Participant F-4
I was thinking about that. I don't use it very much or very often. From time to time the market gets all hot and bothered about somebody being under water or way overvalued, or I will pick up the annual report look at the footnote and say yeah, they have over blown it. I can make my own judgement on that. **[TMKT 4/7, p. 46]**

What I tend to do more frequently if I want to know the so called fair value of the assets I look at the volatility of the net interest margin quarter to quarter because that will tell me a whole lot more about the fair value. How the company is running their business as a going concern. I would say too that the fair value disclosure is used differently depending on where we are in the business cycle. If you think about banking it has been a business where you have a base of funds. At one point in the economic cycle you put it into loans and at another time in the economic cycle it is parked in securities. **[TMKT 4/7, p. 46-47]**

In terms of how I use this I use it occasionally. It depends on the economic cycle and it depends on what the fad in the market is. **[TMKT 4/7, p. 47]**

Committee/Staff/Observer
Do you expect as you get more comfortable with it and you see it more often, you are apt to use it more or would you not care if it did not appear in next year's financial reporting? **[TMKT 4/7, p. 47]**

Participant F-4
I think it would depend a lot on whether I felt comfortable that I understood the assumptions under which those statements were created. Right not I am feeling very uncomfortable with the underlying assumptions in large part because large segments of the balance sheet are totally ignored. It seems to me that it makes absolutely no sense to have on one side of the balance sheet a gain on an asset when on the other side of the balance sheet you are losing money on those demand deposits. **[TMKT 4/7, p. 47-48]**

That is a fact that people who don't cover financial companies often fail to acknowledge. It seems to me that must be taken into account for any kind of fair value in financial institutions to have kind of meaning whatsoever. **[TMKT 4/7, p. 48]**

Committee/Staff/Observer
I would like to raise a question I wanted to ask of [participant F-1] and [participant F-2]. My notes say, [participant F-1], that you don't trust the fair value information and [participant F-2], I think you said you don't use it. **[TMKT 4/7, p. 48]**

Participant F-2
In our spreadsheet numbers we haven't used those numbers. I am not saying that we ignore the information. **[TMKT 4/7, p. 48]**

Committee/Staff/Observer
Let's try to fast forward six years and let's presume that the numbers are generally more reliable and you are a lot more comfortable with the kinds of assumptions. Let's assume it ends up being better information, more reliable information, could you see yourself looking more towards the 107 data and actually discarding information that is on the balance sheet? Is that a reasonable outcome? **[TMKT 4/7, p. 48]**

Participant F-2
I don't know if we ever will discard historical data. We would use it more. **[TMKT 4/7, p. 48]**

Committee/Staff/Observer
You would use what more? **[TMKT 4/7, p. 48]**

Participant F-2
Fair values and consider it and become more comfortable with it but I don't see I would completely discard historical data. **[TMKT 4/7, p. 49]**

Participant F-6
I think that the mix of assets and liabilities in a bank is really the problem. You think of an individual asset and its change in value, it is really not, it is the value change in the combination of debt and assets. But conversely in an insurance company. There really isn't an integral matching of assets and liabilities. **[TMKT 4/7, p. 49]**

I really don't think the concept of individual asset or liability values is as important as the value change associated with it -- that is the way the banks are doing it internally. There is a push, to determine the earnings impact of your interest sensitivity position at any point in time based on your position. **[TMKT 4/7, p. 49]**

Let's talk about capital value or the value change impact on capital. But it isn't dealing with it asset by asset it is dealing with it in aggregate, the net position. I would only say where assets and liabilities have interest rate sensitivity then I wouldn't believe there is value separating those two and in fact the market value or the net position is what is important. **[TMKT 4/7, p. 49]**

Participant F-4
I would like to do a fast rewind to about six or seven years ago and let's talk about inflation accounting. Why don't we see inflation accounting statements today. The point I would like to make is that for any given economic environment there is going to be positive and negative effects for every single company. **[TMKT 4/7, p. 49-50]**

I must admit that I am feeling pretty skeptical about this 107 disclosure in large part because I would anticipate that five years from now we will be in an economic environment that will be vastly different than today. I feel somewhat skeptical that even as I get used to the assumptions that underlay the 107 disclosures, I will continue to use historical cost accounting because it will be more meaningful and it will be something that I know is relatively verifiable. **[TMKT 4/7, p. 50]**

Participant F-1
I think your question was directed at me in part and if 107 has a shelf life, like anybody in my profession I am very opportunistic, if you give me information and I can make some use of it I will use it. So yeah I would say the odds are that if that information is still around five or six years from now and I found some way to make it useful I will use it more but I am just going to suggest again that the whole notion of a value accounting system is conceptually flawed. I just think we are on a conceptual dead end here. **[TMKT 4/7, p. 50-51]**

Committee/Staff/Observer
Well I guess it gets back a little bit to is there a difference between the usefulness of value information for a financial services company versus a manufacturing company. By the makeup of this group and just by thinking about market values and fair values we tend to think

more about financial assets and liabilities, but can you make the point that value information might be more important for a manufacturing company rather than for a financial institution. **[TMKT 4/7, p. 51]**

Someone said at one of our earlier meetings that for financial institutions the future is really playing out transactions that have already taken place. You have already made the loan and now the issue is what income stream is going to come from that. But with a manufacturing company you are trying to evaluate transactions that are going to take place in the future. **[TMKT 4/7, p. 51-52]**

Is there some implication for a manufacturing company, because of that phenomenon, that influences the usefulness of value information? **[TMKT 4/7, p. 52]**

Participant F-3
It is the other way around. **[TMKT 4/7, p. 52]**

Committee/Staff/Observer
Well that is what you are all saying and that is what we heard before. But we haven't talked much about manufacturing companies or industrial companies, non-financial companies. **[TMKT 4/7, p. 52]**

Participant F-6
When we analyze commercial individual company analysis we use market values. We make an analysis of its ability to pay from its going concern value, and then we separately look at value. We get appraisals on the facility which is not based on the use of the building but its replacement use in the market place. **[TMKT 4/7, p. 52]**

Committee/Staff/Observer
Is that your irrespective of whether it is a collateralized loan, or would you still look to fair values? **[TMKT 4/7, p. 52]**

Participant F-6
Yes. In fact on large corporate unsecured loans we still talk about fall back, which is not collateral. We don't have a security interest in that asset but we understand the fall back alternative to going concern value on the business. We do going concern but we are not buying the value. We look at the going concern cash flows, the ability to service its debt, and then we do look at plan B which is collateral. **[TMKT 4/7, p. 52-53]**

Committee/Staff/Observer
So you determine how to disaggregate value for your plan B? **[TMKT 4/7, p. 53]**

Participant F-6

Right. We do use value information and it is important but it is not our primary focus it is more of a fall back. We hopefully don't enter into a loan under the presumption that it won't be repaid from the primary source-cashflows. **[TMKT 4/7, p. 53]**

Participant F-2

We don't in our group follow any equities so that value accounting maybe more useful to equity analysts, I don't know. But I think we are primarily interested in the cash flows or available debt service unless there is a plan to sell off nonstrategic assets. Value of the assets is not as important as the ability to generate cash flows. **[TMKT 4/7, p. 53]**

Participant F-3

Let me throw out one quick strange idea. I'm a bank analyst and I am pretty happy that I know where to find the types of information I need. Maybe it would be more interesting, more valuable to me to have information, fair value information, on a manufacturing company because I am not familiar with that environment. I don't normally do it and maybe it is of more value to the casual user to have some idea of what the fair value of inventory is. **[TMKT 4/7, p. 53-54]**

Participant F-4

The other notion that just occurred to me, again from someone who doesn't follow manufacturing companies over the last decade manufacturing companies have increasingly entered into a whole variety of financial transactions. **[TMKT 4/7, p. 54]**

There are enormous financial assets and liabilities both on and off balance sheets and that perhaps, echoing what [participant F-3] just said, maybe fair value is more important than any of us in this room realizes. Maybe we are underestimating or understating all of those financial transactions in industrial companies. **[TMKT 4/7, p. 54]**

Committee/Staff/Observer

I think we have covered the issues we wanted to cover in 1H and 1I. 1H. Fair value information is considered more relevant for assets which have a readily determined market value. 1I. Fair value information is used in analysis to reflect current economic and market conditions. 1H being fair value information is considered more relevant for assets which have a readily determined market value, I think you have helped us understand the liability issues associated with value however you define it. **[TMKT 4/7, p. 54-55]**

If anyone would like to make comments on either 1H or 1I, I would certainly be interested in hearing those. What I would like to do before we take a break and get into the examples is focus on the assumptions on page 24 of the materials that you were provided with in advance. I would like to very quickly run through those assumptions and attempt to understand if we are hearing you correctly. **[TMKT 4/7, p. 55]**

Question 2 A. Users want to preserve the information currently presented under the historical-cost model. We hear that loud and clear. **[TMKT 4/7, p. 55]**

Question 2 B. Users' primary need is for information to estimate the "core" or ongoing earning power of the entity. We haven't talked about that to any great extent today but my sense is based on the input we have gotten from other meetings that is clearly important and ranks among items with a high priority. **[TMKT 4/7, p. 55-56]**

Committee/Staff/Observer
I think that was clear from the discussion today too, particularly [participant F-4]'s concern about volatility. **[TMKT 4/7, p. 56]**

Participant F-2
To comment on B, I think for financial institutions the actual earnings power isn't really what services its debts. I mean they are financing assets to a great extent. But a manufacturing company's earnings power services its debts, so I think there has to be more attention to what the values on the balance sheet really are. **[TMKT 4/7, p. 56]**

Participant F-4
I would also like to add that the only reason we are determining core or on going earning power is that each of us is determining what a stock is worth. I want to be sure that point comes through because that is the only reason we make that determination. **[TMKT 4/7, p. 56]**

Committee/Staff/Observer
Understood. It is what you apply a multiple to. Question 2C, users generally view the entity as a going concern in their investment and credit decisions. **[TMKT 4/7, p. 56-57]**

Participant F-1
Generally. We also have got plan B. **[TMKT 4/7, p. 57]**

Participant F-6
Yes, but plan B it is situational. I mean there are credit decision we do make based on plan B, distressed paper sales. **[TMKT 4/7, p. 57]**

Committee/Staff/Observer
So unless you advise me otherwise I would keep generally in there. Question 2D. Users consider value information in their investing and lending decisions. I guess I might add sometimes or some users. **[TMKT 4/7, p. 57]**

Participant F-5
Some users sometimes. **[TMKT 4/7, p. 57]**

Committee/Staff/Observer
I am getting a different message today than I have gleamed from other group discussions that we had and I think we need to polish that point with some hedges. **[TMKT 4/7, p. 57]**

Question 2E. No single method provides the best measure of value in all circumstances and preparers are in the best position to determine the methods or assumptions necessary to estimate or determine the methods or assumptions necessary to estimate or determine value. I think we need to focus on that a little bit in the interest of clarity or clarification. **[TMKT 4/7, p. 57-58]**

Participant F-6
The only thing I would say on this is that if we all agree we are in the liquidation scenario and what am I going to get out of it, we probably are reasonably close. The issue is we are using liquidation or not. The problem is which value we are using at which point in time. **[TMKT 4/7, p. 58]**

Committee/Staff/Observer
Right. Would it be helpful if our purpose and objective is to develop a set of financial information for general purpose use, obviously, in a going concern concept? We have special rules if a company doesn't qualify as a going concern. So the kinds of information and disclosures and the recommendations that the special committee will make will be in the context of a going concern environment. **[TMKT 4/7, p. 58]**

Participant F-6
The problem with it is that assumes going concern. [Name deleted] will be a going concern or each of its franchises and each of its business lines is going to continue to operate. I would argue that there will be some strategic thinking about that, and so while you may make that broad going concern assumption there are subparts of that decision and going concern may not be the right assumption. **[TMKT 4/7, p. 58-59]**

Committee/Staff/Observer
And then we would apply the special rules for that segment of the business. **[TMKT 4/7, p. 59]**

Participant F-4
One of the problems I have with this statement is first I wrote in preparers are probably in the best position and then I said wait a minute, the issue I have with this statement comes back to the questions we had on value before. My job and the whole reason I am doing what I am doing is to make a value determination. Whether or not to buy an equity and when you are buying an equity all you are buying is future cash flows. So I need to make some kind of determination as to what that value is and it seems to me that somewhere in this sentence you might want to include a notion that preparers are in the best position to record the value at any moment in time. The accounting profession is so critical to what we do because you tell us

what has happened and where the standing of the firm is at any given point in time. I am not quite sure how to weave all this in but I think, to me, it is an important distinction. **[TMKT 4/7, p. 59]**

Committee/Staff/Observer
What I will take away from this, unless you correct me, is that because there are so many different ways to determine values the preparer may not be in the best position to understand how all users will use value information. Therefore the determination of value should be driven by what the users particular purpose or objective is. **[TMKT 4/7, p. 60]**

Participant F-3
In addition I don't know if preparers are in a good position, but to the extent management may want to see a higher value and we know this is subjective. It is a good position but again there will be pressure on management to come up with a higher number. **[TMKT 4/7, p. 60]**

Participant F-5
It may not be the best position at all. They may be in a good position to do it but it may create a very suspect value. **[TMKT 4/7, p. 60]**

Participant F-3
There is a bias. **[TMKT 4/7, p. 60]**

Committee/Staff/Observer
Question 2F. With respect to the last item that comes in two pieces, if value information is included in the financial statements, disclosure should include at a minimum the following; the sources used by preparers to determine value for individual assets and liabilities or groups or categories of assets or liabilities, second the methods or techniques used by preparers to determining value information for assets or liabilities which are not publicly traded. This would include the detail assumptions that would enable the user to evaluate what is presented. **[TMKT 4/7, p. 60-61]**

Does that as modified serve in part to summarize what we have heard? **[TMKT 4/7, p. 61]**

Participant F-3
I would agree. But the note I have here is I think it takes a lot of explanation. **[TMKT 4/7, p. 61]**

Committee/Staff/Observer
I agree. I don't know how the [names deleted] of the world do that. **[TMKT 4/7, p. 61]**

Participant F-3
I don't think it is one paragraph. **[TMKT 4/7, p. 62]**

Committee/Staff/Observer
Would you use F at all? **[TMKT 4/7, p. 62]**

Participant F-1
Would I use F at all? Well as I said I am very opportunistic and certainly for it to be of any value I think that kind of disclosure of how the information is derived is essential otherwise I am looking at random numbers. **[TMKT 4/7, p. 62]**

BREAK

Committee/Staff/Observer
[Discussion of illustrative examples] We wanted to share these examples with the idea of getting down to some detail and getting our hands a little dirty and then after that see if maybe there is something of use that comes from some of these presentations that wouldn't be automatically identifiable at the 50,000 foot level. So that is our objective and we appreciate you bearing with us through this exercise of numbers. **[TMKT 4/7, p. 62-63]**

With that statement I would like you to try to walk us through these illustrations and examples and we can also talk about issues that surface as we go through them. **[TMKT 4/7, p. 63]**

Committee/Staff/Observer
I think we would like to start this morning with the manufacturer. You have three different illustrations. As a bit of an overview, illustration 1 simply would categorize assets that were not used in operations and we put those at value. **[TMKT 4/7, p. 63]**

For example, investments which are basically non-operating investments and land held for resale. We also wanted to get your reaction to whether or not it made sense to put those at value. As you can see from the assumptions, our assumptions were that for most of the current assets and liabilities, such as trade receivables or trade payables, because of their short term nature and the values recorded in the current model would probably be a reasonable approximation of what they could be settled for in the market place. **[TMKT 4/7, p. 63-64]**

For the second illustration, we added inventory and property plant and equipment at value. In the third illustration we wanted to pursue the concept of whether or not it made sense to have an alternative measure of profit. **[TMKT 4/7, p. 64]**

In all of these illustrations we have utilized the concept of a comprehensive income statement so that you would still continue to have the same kind of measures you have in today's income statement. You would be able to see your gross margin measured before value changes on the

same basis. In illustration 3 there would be a slight difference between the value column and the historical column. **[TMKT 4/7, p. 64]**

I guess we would like to start off with your initial reaction. Did the find the illustrations at enlightening, useful? **[TMKT 4/7, p. 64]**

Participant F-6
Well I jumped on the time value one which bothered me particularly with long term debt. The recognition of the increase in value of debt which for this company caused a loss. To me the debt has a future reduction in cost. If I am taking the current value of the debt assuming a new 6% yield on that debt than I have got to reflect that in my costs. I saw you did that with the adjustment in the fixed assets you therefore had an adjustment to depreciation for the fair value effect of depreciation. But you didn't do it on time value. **[TMKT 4/7, p. 65]**

Committee/Staff/Observer
Well as an option would it make some sense to try and show cost of sales on a value basis using current inventory cost. **[TMKT 4/7, p. 65]**

Participant F-6
Well in this case I was looking at current depreciation in particular and I was relating that to debt where I made no adjustment to my current interest expense for that same type of calculation. I guess the question is if you are going to do it you have to do both. I don't think people have really thought through that issue and I am not sure which way I like it. **[TMKT 4/7, p. 65]**

Participant F-2
I think the whole problem is that maybe it means more for the balance sheet but not much for the income statement. **[TMKT 4/7, p. 65]**

Committee/Staff/Observer
So you are saying the income statement really didn't do much for you? **[TMKT 4/7, p. 66]**

Committee/Staff/Observer
You mean illustration 3? What about illustration 2 where the value changes are all separated and shown below the line. Just to clarify I think we are emphasizing that above the line, on page 2 of illustration 2, the $1.55 earnings per share. That is what you now know as net income and that would be preserved and be the main featured number. **[TMKT 4/7, p. 66]**

Committee/Staff/Observer
What you would get in illustration 2 that there has been some change in the value of inventory held because of price increases as your cost increases. **[TMKT 4/7, p. 66]**

Participant F-4
When I went through this I got a horrible headache. That is no reflection on the data. I am just trying to think through exactly what we are looking at and the thought occurred that what we are really measuring is opportunity cost. That is what we are really measuring because if you have got debt at 10% and the current market is 6%, you have an opportunity cost. **[TMKT 4/7, p. 66-67]**

If you would have an opportunity cost in terms of refinancing the debt on one hand, you also have an opportunity cost on the other side that is not being reflected and we don't know what the net of those two are. It also occurred to me, is it appropriate to reflect that opportunity cost in the income statement and the balance sheet? **[TMKT 4/7, p. 67]**

I am not sure I know what my opinion is on this whole exercise but I don't think anyone else does, but that thought occurred to me and I think that the consideration that maybe we haven't really thought about. I looked through at what these measurements generate and thought long and hard about whether this means anything to me. Do I get anything incremental here? What I get incremental is someone else's estimate of what I am going to do anyway. **[TMKT 4/7, p. 67]**

Committee/Staff/Observer
Let us pursue that point for a minute. Would you do something similar to this? **[TMKT 4/7, p. 67]**

Participant F-4
I would probably do something along these lines but I would like to make entirely different assumptions. **[TMKT 4/7, p. 67-68]**

Committee/Staff/Observer
Along the lines of which illustration? **[TMKT 4/7, p. 68]**

Participant F-4
Oh you can pick any of them. It would depend greatly on the economic environment, on my outlook. **[TMKT 4/7, p. 68]**

Committee/Staff/Observer
Let's start back maybe with illustration 1 which is the most simple of the three. If I understand what I have been hearing, people are trying to perhaps focus on those earnings to which a multiple should be applied and then those earnings that might be one offish or those earnings where the multiple ought to be one. **[TMKT 4/7, p. 68]**

So what we have tried to do with illustration 1 is to say, what are the assets and liabilities. Then what are earnings that should have a multiple other than one attached to it or associated with it. Those operating assets and liabilities that give rise to the core earnings and those

assets and liabilities that are not part of operations. We think you have been telling us that nonoperating probably should have a multiple of one associated, those investments that are not part of the operating assets and liabilities, maybe marketable securities and its land held for sale. So the non-operating assets, if we ignore long term debt for purposes of simplicity, that is what we have tried to characterize in illustration 1. **[TMKT 4/7, p. 68-69]**

Participant F-6
But to comment on EPS. I mean I do so many other things with this. I have now inflated my earnings and I am not reflecting future impacts of that in the other parts of the income statement by converting and adjusting. This analysis doesn't show me the change in depreciation rate or change in the interest cost or -- well you might but this presentation 1 doesn't give that to me. It strictly gives me the one liner, you know, the assets went up and I assume that is net of tax. But it does distort my understanding of efficiency of utilization of capital and so forth. **[TMKT 4/7, p. 69]**

Committee/Staff/Observer
Suppose this illustration had two assets. A change that each went to $2,000 so you had $4,000 between the two of them instead of $13,000 and there was some reliability to it. **[TMKT 4/7, p. 69]**

Participant F-6
Where are we at? **[TMKT 4/7, p. 69]**

Committee/Staff/Observer
Investments in land held for resale. Illustration 1, page 1. There are only two assets that change. Suppose that the fair value as of December 31 was $2,000 for each of them which would make $4,000 in total instead of $13,000 in total. This is a $9,000 decrease in a company which total stockholders' equity at the beginning of the year was $39,000. You have got almost a 25% decrease. **[TMKT 4/7, p. 69-70]**

Participant F-4
You are confusing me. You are moving faster than I can follow. **[TMKT 4/7, p. 70]**

Committee/Staff/Observer
Total stock holder's equity next to the last line, third column from the right, the beginning of the year was $39,150 and I have given you a scenario where we have just taken off in a year 9,000 so it is roughly a 25% decrease. **[TMKT 4/7, p. 70]**

Committee/Staff/Observer
You are saying that the investments in land held for sale rather than having an increase in value during the course of a year decreased. **[TMKT 4/7, p. 70]**

Committee/Staff/Observer
I think it is far more meaningful to consider these things in terms of where the profession has come. Not just the way we measure things and maybe analysts too. Let's take a look at the down side. You know it is easy to say we don't care if it is going up. **[TMKT 4/7, p. 70]**

Let's us take a real life situation. Let's assume these assets, major assets of this company go down to 4,000 so you have a $9,000 decrease. I mean it is real. I know fair value can be defined any which way you want but if you were doing a personal balance sheet of [participant F-6] and these were your assets and at the end of the year they are only worth $4,000. Define worth any way you want. Isn't it meaningful that the total stockholders' equity of this company went down by almost 25% and on the historical cost model has not recognized it at all. **[TMKT 4/7, p. 70-71]**

I understand you are going to come to me and say don't take the 9,000 into income. Don't penalize core earnings because maybe it will come back next year. But wouldn't it be meaningful? **[TMKT 4/7, p. 71]**

Participant F-5
I think with investments it would be relatively more meaningful because presumably there is some type of transactional method telling me the value went down. But with land held for resale, I don't know that it is meaningful. We have all seen how valid real estate appraisals have been in the last 4 years. **[TMKT 4/7, p. 71]**

Committee/Staff/Observer
It is land held by a savings and loan in Texas. **[TMKT 4/7, p. 71]**

Committee/Staff/Observer
Let's paint a different picture for a minute and somehow or another the accounting principles do not allow us or didn't call for writing that land down. **[TMKT 4/7, p. 71]**

Committee/Staff/Observer
If you are talking about the reliability of the numbers, I think you would agree that there could be a situation where it would be widely accepted that equity had a significant wipe out element because there was a significant wipe out on that asset. **[TMKT 4/7, p. 71]**

Participant F-3
Isn't there some point today at which current accounting would pick up that kind of decrease in value? With your savings and loan example it should have been caught. We are supposed to be valuing land at net realizable value. **[TMKT 4/7, p. 72]**

Committee/Staff/Observer
What [committee/staff/observer] says is right that the range of determining value for purposes of assessing a write down can range from future cash flows associated with that asset on a

gross basis or on a discounted basis and when you have got that kind of a range for determining value you may not get a valid answer. **[TMKT 4/7, p. 72]**

Participant F-6
The issue is for the accountant to make the determination in the financials that it is being liquidated, it is held for sale therefore make the adjustment. If it is a situation where it is not clear, supplemental footnotes may get to the point. That might be an alternative to what is presented. **[TMKT 4/7, p. 72]**

Committee/Staff/Observer
I think you have to assume that the historical cost column in each of these illustrations reflects an appropriate application of existing principles including any impairment write down. Assume this adjustment which [committee/staff/observer] is talking about would go beyond that for whatever reason. **[TMKT 4/7, p. 72]**

Participant F-4
Basically any event that would affect the value of either investments and/or land for resale, be it a manufacturing company or financial company, would be recognized by the market. With all of our different valuation opinions, we are going to mark that stock down long before the accountants pick up on them and in many instances you can go back and look at the Savings and Loan examples. In some cases people continued to buy the stock to push the price up but there were other doubting Thomas' out there that were selling every share. That is what markets are made of. What if this was a mark down and what does that mean for equity. Until it is realized -- Is it real? **[TMKT 4/7, p. 72-73]**

Committee/Staff/Observer
[Participant F-4], suppose you were asked to invest, you personally were asked to invest in a small privately held company somewhere in the Heartland and nobody was following that company because it was private to begin with and they gave you this historical cost balance sheet dated December 31 with equity of $39,150. Then assume the facts as I presented them to you. Is it a fair presentation -- the auditors did right but they didn't point out the impairment and you invested your money on February 10th. You then discovered that the fair value -- and I don't care how you describe fair value, of that Company went from 13,000 to 4,000 and your money is invested in that company. **[TMKT 4/7, p. 73]**

Participant F-6
The other side to this is though that if you write it down to 4,000 and I look at it and turn it down and go to another investment. Then the next week I read in the paper that the stock is up 20% because they sold that asset for $7,000 or $8,000. I have to know why you assume $4,000 or why you assume $13,000 and supposedly that is already here. If it is close, if it is on the borderline, you shouldn't automatically go to liquidation analysis whether they intend to hold or they have got an offer for $4,000. They are saying I am not selling it, this is isn't for

sale at that price. I am in for the long haul with this asset and you as an accountant will tell got to take the worst case, you know, let's take 4,000. **[TMKT 4/7, p. 74]**

Committee/Staff/Observer
Let me try to help. I guess I would like to ask you to help us understand perhaps better and a little more crisply your concerns. I would like to ask you each individually. **[TMKT 4/7, p. 74]**

Let's assume for purposes of these examples that land is held for sale. Let's assume this company is [name deleted] and let's assume the land held for sale. Its cost is $8,000 and its value is 100,000+. In 1950 the land was acquired for future expansion. Given what has been going on over the years [name deleted] has decided not to use that land to expand, and has chosen to put it on the market. **[TMKT 4/7, p. 74-75]**

Let's assume further that the appraised value of that land is $100,000+. What I would like to know from each of you is would you prefer the $8,000 cost, with no particular disclosure associated with the appraised value or would you prefer to see the $100,000+ reflected on the balance sheet with disclosures associated with how it was determined. Or would you prefer the $8,000 on the balance sheet with some disclosures associated with the fair value and how that fair value was derived at. **[TMKT 4/7, p. 75]**

Do I need to clarify what I am asking? [Participant F-1], can I start with you, I hate to keep going left to right, I guess that is just the way I think. **[TMKT 4/7, p. 75]**

Participant F-1
I guess with those three options I would prefer the $8,000 on the balance sheet with disclosure of additional information. **[TMKT 4/7, p. 75]**

Participant F-2
I would probably choose between the last two options. **[TMKT 4/7, p. 75]**

Committee/Staff/Observer
Indifferent with respect to whether the $100,000 is recorded as long as the disclosure is there. **[TMKT 4/7, p. 75]**

Participant F-3
I think two or three is certainly preferable than the first one. **[TMKT 4/7, p. 75]**

Committee/Staff/Observer
Assume that in this particular case we asked about the relevance of the 1950 historical cost of $8,000. **[TMKT 4/7, p. 75-76]**

Participant F-3
I agree with that. I like the additional disclosure, I like historical cost but with the additional disclosures of what the current value. I can do with it what I want. **[TMKT 4/7, p. 76]**

Committee/Staff/Observer
And you would opt with either the second or the third as long as the disclosure was there. **[TMKT 4/7, p. 76]**

Participant F-3
What was the first choice that they are ruling out? **[TMKT 4/7, p. 76]**

Participant F-6
Cost without supplemental disclosure. **[TMKT 4/7, p. 76]**

Participant F-1
If I could just interject one further thought here and in response to [committee/staff/observer]'s question. If I was going to invest or I was analyzing a company that had 25% of its net worth in non-business assets of a character that I knew had price volatility, I sure would investigate the extent to which the balance sheet figures reflect current values. If I didn't follow this process and I made that investment that was my fault. **[TMKT 4/7, p. 76]**

Committee/Staff/Observer
But shouldn't the statements more closely reflect what you are going to find out? **[TMKT 4/7, p. 76]**

Participant F-6
I would say giving some reasonable controls on it I would prefer the one with $10,000 on the balance sheet with the $8,000 cost disclosure once the decision has been made that it is for sale and again it is assuming that it is the right value. **[TMKT 4/7, p. 76-77]**

Participant F-4
I agree with [participant F-6] but I would switch it around. I would put the cost on the balance sheet and have the additional disclosure because I think the cost is the more reliable measure than the current appraisal which could change tomorrow. **[TMKT 4/7, p. 77]**

Committee/Staff/Observer
If I made this a company that was formed in 1906 and this was when it was purchased in 1906 for $100 would you still feel the same way? **[TMKT 4/7, p. 77]**

Participant F-4
I would feel the same way. **[TMKT 4/7, p. 77]**

Committee/Staff/Observer
Even though the $1.00 is very reliable but of little relevance? **[TMKT 4/7, p. 77]**

Participant F-4
Yes. **[TMKT 4/7, p. 77]**

Participant F-5
There is not even any question in my mind which is preferable. The preferable choice is to have the cost on the balance sheet with supplemental disclosure because we have all seen what appraisals are worth in the last five years and to assume because some appraiser gives land a value of x that that is what you should reflect on the balance sheet I think is ludicrous. More often than not transactional value and appraisals don't bear any resemblance to reality for land, as opposed to an occupied apartment building or something of that sort that has cash flows. **[TMKT 4/7, p. 77-78]**

Committee/Staff/Observer
So you would allow management to be responsible for reported earnings that allows them to choose when they reflect the gain? **[TMKT 4/7, p. 78]**

Participant F-5
They will reflect it when they sell it. They may have an appraisal of 100,00 but then next year when they sell it they might only get 3,000. **[TMKT 4/7, p. 78]**

Participant F-6
But that is the reliability question again and it is also the method question. I believe there is a difference between reliability and method. As long as I am comfortable with the method it is manipulative to allow them to make the determination of recognition. **[TMKT 4/7, p. 78]**

Participant F-3
We have an example of cost accounting with supplemental disclosure of market value with the Japanese banks. They have substantial equity portfolios carried at cost and there has been recent disclosure of what the value is for capital standards. Think about what the [name deleted] has done over the last five years, and then think about trying to put together a historical summary of capital and profitability ratios. **[TMKT 4/7, p. 78]**

If the record showed equity, adjusted for the current value of the equity securities the only thing driving capital ratios would be the change in [name deleted]. I wouldn't see anything else reflected but that one factor so I would throw that number out because I want to look at other things. **[TMKT 4/7, p. 78-79]**

Participant F-6
But the offset to that is whether what was economic value when stocks were worth what they were supposedly worth in 1988 and 1989. They were getting pretty damn weak returns on

their investments in terms of their overall yields. If you took a true market value and say that a smart investor is incented to make good economic decisions to improve their overall return on equity, true equity as opposed to book equity. I mean we live off a return on book equity which is continually distorted. **[TMKT 4/7, p. 79]**

Participant F-4
I would like to bring up another example that may be along these lines. I understand [Company A] carries its brand name on its books for $1. I want to make sure it is recognized. [Company B] has this huge position in [Company A] that is how I keep hearing about it. **[TMKT 4/7, p. 79]**

Committee/Staff/Observer
It is also on their books at $1.00. **[TMKT 4/7, p. 79]**

Participant F-4
So it comes to a comparable notion of what [participant F-3] was talking. The perceived value of the [Company A] franchise gets larger or shrinks depending on whether there are price wars in cola. The value of [Company B] is going to move all over the place and the balance sheet going to move all over the place and the comparability from period to period will be lost. We analysts can make our own estimates of what we think it is worth, we know the facts. **[TMKT 4/7, p. 79-80]**

Participant F-3
I like the [Company B] example too. The way I think most of us would look at [Company B] is to look at the current accounting and say that is a nice way to look at this company. I can look at the capital issues, I can look at profitability and I can see there is an additional amount which is there, maybe they can get it, maybe they can't. **[TMKT 4/7, p. 80]**

Committee/Staff/Observer
If they are selling off amounts each year of [Company A] stock and reaping very significant gains. Is that useful information to have that flow in at management's discretion? **[TMKT 4/7, p. 80]**

Committee/Staff/Observer
Wouldn't you adjust it out? **[TMKT 4/7, p. 80]**

Participant F-3
Absolutely. The first thing I do. **[TMKT 4/7, p. 80]**

Participant F-6
But in terms of your measurement what we do is because it is not in a controlled environment. Right now you adjust it to the capital account but you don't change the earnings measurement. They start to bleed it into the earnings stream, you are quick to adjust the earnings account but

do you go back and fix the capital structure because of the adjustment to the earnings stream? You adjust earnings because they are bleeding. You push this side up and then measure the return. I mean I am not uncomfortable with market value because right now management makes a lot of bad decisions based on historical cost and in a sense some of this is positive. There are certain times you don't want to look at individual assets and liabilities. [Company A] stock is a classic example. Nothing on the other side of [Company B's] balance sheet moves in any way consistent with the economics of that stock. **[TMKT 4/7, p. 80-81]**

Where I have hedge positions of loans and deposits that move together, I am looking at the net. Yet I get people who want to work on one side and forget about the other. **[TMKT 4/7, p. 81]**

Committee/Staff/Observer
If we took your thoughts and increased the value of the land from 8,000 to 10,000 in the [name deleted], how would you reflect the $2,000 in the income statement or would you? The choices could be to display it in the income statement with some kind of disclosure, display it as in illustration 1 as something akin to an extraordinary write off or something outside of core earnings. Or do you not even run it through the income statement and credit it directly to capital or equity because you would prefer the 10,000 on the balance sheet? **[TMKT 4/7, p. 81-82]**

Participant F-6
Well it depends when the gain occurred. If I am in a perfect world I can't just start the day one change occurs I have to look over a period of time. **[TMKT 4/7, p. 82]**

I need to have "real" changes (offers) in value be reflected in the income statement so that I can evaluate the overall quality of the individual decisions being made. Equity and returns on the equity invested, asset values and the returns on the individual assets. Operating earnings are one thing for assets held for sale you have really got to justify your carrying cost. **[TMKT 4/7, p. 82]**

Committee/Staff/Observer
So you would run it through the income statement outside of core earnings? **[TMKT 4/7, p. 82]**

Participant F-6
Yes. But on a continuous basis. **[TMKT 4/7, p. 82]**

Committee/Staff/Observer
You would mark it to market. **[TMKT 4/7, p. 82]**

Participant F-6
The problem you have the first time is that you are going to get one lump sum. **[TMKT 4/7, p. 82]**

Committee/Staff/Observer
If the sale occurred on March 1st and the company was reporting on March 15th for its year ended December 31, in its December 31 financial statements would your answer change? **[TMKT 4/7, p. 82]**

Participant F-1
No I think in that circumstance with the fact of the transactions I might properly show it in a footnote. **[TMKT 4/7, p. 82-83]**

Committee/Staff/Observer
What if it is was 8,000 and sold shortly after the end of the year at 4,000? **[TMKT 4/7, p. 83]**

Participant F-1
The same thing. December 31st balance sheet in my mind is a December 31st balance sheet. **[TMKT 4/7, p. 83]**

Committee/Staff/Observer
I have a question directed to [participant F-5] and to [participant F-1]. I think you counseled that transactions ought to drive the carrying amount on balance sheets. We will stay with historical cost until we have something that knocks us off to something else. It is clear to me what your counsel is on the up side, that is where we have appreciated assets and understated liabilities. But on the down side does your counsel change? **[TMKT 4/7, p. 83]**

Participant F-5
No, not at all. **[TMKT 4/7, p. 83]**

Committee/Staff/Observer
So even if we have the S & L crisis again keep the assets at the high historical cost and provide disclosures only. **[TMKT 4/7, p. 83]**

Participant F-5
Yes. You keep going back to the S & L example so I will stick with that. I am not comfortable using appraised values for real estate on the down side of the real estate cycle. But the fact of the matter is that when those loans were underwritten on the up side it was those same appraiser's worth that was used as a basis for extending those credits. Is this a real estimate of what they are going to realize when they transact that piece of property? My answer is no. I would rather make my own subjective estimations of its value until they actually sell that asset on the up or the down side. **[TMKT 4/7, p. 83-84]**

Committee/Staff/Observer
If your concern was reliability, then if the asset was sold on January 5th, before the reporting date, why wouldn't that be reliable enough to reflect it on December 31? **[TMKT 4/7, p. 84]**

Participant F-5
Because when I read an income statement or a balance sheet that is dated December 31 I presume that its means up to December 31. **[TMKT 4/7, p. 84]**

Committee/Staff/Observer
It is not only reliability. It is transaction oriented as well as reliability. **[TMKT 4/7, p. 84]**

Participant F-5
If I own a bank stock and the yield curve inverts between December 31 and the 17th, I don't expect that to be reflected in the prior period income statements. Although that information would enter into my investment decision making process. **[TMKT 4/7, p. 84]**

Committee/Staff/Observer
You would like information about the appraisal disclosed? **[TMKT 4/7, p. 85]**

Participant F-5
As a supplemental disclosure certainly. It would be useful but I just would not want to post it to the balance sheet. **[TMKT 4/7, p. 85]**

Committee/Staff/Observer
But then in your analysis you would reflect it in the historical? **[TMKT 4/7, p. 85]**

Participant F-5
If it happened post the time period? Only if it was a significant dollar amount. **[TMKT 4/7, p. 85]**

Committee/Staff/Observer
So you would adjust the historical financial statements and your analysis to give rise to the subsequent transaction? **[TMKT 4/7, p. 85]**

Participant F-5
No, no. I would not. Unless it is significant. A disclosure would help. A supplemental footnote, possibly. I would not adjust income statements and balance sheets dated prior to the date of transaction for the transaction. **[TMKT 4/7, p. 85]**

Committee/Staff/Observer
You would in your analysis. **[TMKT 4/7, p. 85]**

Participant F-5
Right, right. I would put it in the first quarter. **[TMKT 4/7, p. 85]**

Committee/Staff/Observer
How would you use that information in making your buy/sell recommendation? **[TMKT 4/7, p. 85]**

Participant F-5
Well it would be something that is occurring in the current year not in the prior year's numbers. **[TMKT 4/7, p. 85-86]**

Committee/Staff/Observer
In January you said it would affect your potential decision to invest or not invest in that company. I think what [committee/staff/observer] is asking is whether you would adjust earnings that were reported as of December 31. But now you are sitting here trying to make an investment decision on January 17th. What do you do exactly? **[TMKT 4/7, p. 86]**

Question 4B. How would you use the information in your investing or lending decisions? **[TMKT 4/7, p. 86]**

Participant F-5
There are all kinds of information that enter into investment decisions on a company happening at all times, press releases currency markets are changing, interest rates are changing and so forth. But when I read a balance sheet or an income statement I want it to reflect what has happened up to the date which is stated at the top of the page. **[TMKT 4/7, p. 86]**

Committee/Staff/Observer
Would you feel that way for all information subsequent to December 31 that affects estimates that are inherent in the December 31 financial statements? Management closes their books on January 10th, and they have an estimate for the settlement of a lawsuit say on December 31. On January 10th new information becomes available. Would you not adjust the December 31 value or would you say the effect of the new information is a first quarter event? **[TMKT 4/7, p. 86-87]**

Participant F-5
Well it would be a first quarter event. I just can't understand any rationale for adjusting the prior period. I just can't see that. **[TMKT 4/7, p. 87]**

Participant F-2
We are getting bogged down in just the accounting and I don't think it is really going to matter as long as that information is disclosed and whether you put it either the first quarter or the fourth quarter. **[TMKT 4/7, p. 87]**

Committee/Staff/Observer
So you can do with it what you want. **[TMKT 4/7, p. 87]**

Participant F-2
Yes. You guys can account for it the way you see fit as long as the information is there. **[TMKT 4/7, p. 87]**

Participant F-5
Look at the other side of the coin, supposing the company at December 31 had a pitiful fourth quarter. They lost money and you guys are preparing their books. Then they say we have this [name deleted] stock for a $1.00 a share. Why don't we sell it on January 15th? You guys put that on the December 31 income statement and show an up earnings year. I don't think that would be an accurate reflection of what happened in the December time period. **[TMKT 4/7, p. 87]**

Participant F-6
I think there has been a lot of talk about a transactional focus. I can be equally troubled by the transaction or manipulation. If you want to back to the S&L crisis, and the land flips that went on there that were supported by transactions. I mean I have never been a strong fan of the appraisal institute but quite frankly they were doing nothing more than reporting what was actually happening. The arms length nature was so untraceable that the government has only been able to prosecute a few land flips successfully and yet the multitude of situations where that happened was unbelievable. The day to day property markets are nothing but a glorified land flip over a long period of time. The Japanese buying [large commercial building]. One minute it is $600 million and the next minute it is not worth $600 million dollars. The transaction doesn't give me any greater comfort. I mean there is undisputed evidence that that was the price which passed hands. **[TMKT 4/7, p. 87-88]**

Participant F-5
But didn't the transaction represent an actual cash flow? **[TMKT 4/7, p. 88]**

Participant F-6
In many cases it does and in many cases it doesn't. The installment sales method, imputed interest cost, deferred payment options, embedded sale lease backs. I mean they have done nothing but estimate what the true transaction was. Even in residential real estate, I buy a house and I like to hear what is going on in my local community to figure out what my house is worth. They spend more time trying to back into what was the real effective transaction price and they don't ever come up with it because there is so much manipulation in transaction price. I like supplemental disclosures. The basic statements should be historical cost. I mean we always have this assumption that when something changes to an investment it is now held for sale. I live in the bank world and that changes analysis and how you reflect it in the financial statements. **[TMKT 4/7, p. 88-89]**

I am not uncomfortable with the current system. Let's be a little conservative and carry historical cost until they sell it but I will tell you that we are all making these one off adjustments. When I get a lender that is out there working they come to credit committee and they change one part of the whole integrated set of financial statements. They miss the other six parts. You know they are over there salting away that [name deleted] stock. Meanwhile I am saying look at these idiots. What is the return on the [its] stock for the last two years, they had 50% of their capital tied up in the [its] stock and what was the return on it last year. Was it up? No they made bad investment decisions last year yet the market will continue to reward them like they have made good decisions when in fact it has been poor. **[TMKT 4/7, p. 89]**

I would suggest to you that particularly with non-operating things, the [its] stock which has nothing to do with the bank and the investments held for sale should be treated more on a value basis. Again it is putting the appropriate value in context for what the strategy in the situation and the accountants are in a good position to make that determination. I didn't say liquidation value. **[TMKT 4/7, p. 90]**

Participant F-4
First, back to this notion about what do you do if there is a transaction on January 5th. We in the equity market are concerned about one thing and one thing only and that is future cash flows and to the extent that this particular transaction affects future cash flows so long as we know what the transaction is and what the gain and loss and the effect on the income statement is we can then go back and adjust our earnings model. I agree with this notion of December 31st. That is what it looked like as of December 31st if you are going to take photographs at a point in time it is that photograph. Now maybe somebody ages dramatically two days later and starts to look like a prune well you take a photograph at that time. **[TMKT 4/7, p. 90]**

I think the other point I want to make comes back to a notion that we have all talked about this morning. Everyone has their own definition of value and if you were to talk to each of us privately there is only one number that we would all refer to and that is cost. At least there is one number that we could all use as a base or a springboard for whatever our value adjustments or analysis might be. **[TMKT 4/7, p. 90-91]**

Committee/Staff/Observer
Most assets and many liabilities are given on the balance sheet because of transactions. A lot of contingent liabilities don't get on the balance sheet as a result of transactions. For those of you who are transaction driven what is your counsel to us on how to value contingent liabilities that get on balance sheets not because of transactions? **[TMKT 4/7, p. 91]**

Participant F-1
My counsel is take them off the balance sheet. **[TMKT 4/7, p. 91]**

Committee/Staff/Observer
Contingent liabilities like [committee/staff/observer]'s lawsuit example, just take them off and disclose them. **[TMKT 4/7, p. 91]**

Participant F-1
Disclose. I am not saying we should try to hide them. I have real reservations and always have about balance sheet contingent entries. **[TMKT 4/7, p. 91]**

Committee/Staff/Observer
What about a warranty liability? **[TMKT 4/7, p. 91]**

Participant F-5
Can I come at the question another way? Suppose that there was a big lawsuit against the company that is likely to be won. Do you think the company securities would be valued any differently in the market place if is disclosed on the balance sheet or in a footnote? **[TMKT 4/7, p. 91]**

Committee/Staff/Observer
If your counsel to us is it is more helpful to us to disclose those things and just provide a balance sheet that represents transactions because I want a benchmark, which is where [participant F-1] has been consistently coming from, and [participant F-5] I sense you are there as well. As long as you understand the basis for it we can help design a product that is most helpful to you. I am not coming at this philosophically or conceptually I am just trying to be helpful. **[TMKT 4/7, p. 92]**

Participant F-1
I think an argument can be made in cases where property has declined in value for lower of cost or market. But I haven't thought it all the way through. I still haven't figured out how to respond to your mutual fund question. **[TMKT 4/7, p. 92]**

Committee/Staff/Observer
[Participant F-5], are you suggesting that in your analysis all the information incorporated in the footnotes carries as much weight as information that is recognized? **[TMKT 4/7, p. 92]**

Participant F-5
Well yes. I am suggesting that any changes to the model should be helpful to investors in the market place to allow them to make better informed decisions. I don't think it matters to the markets whether it is in the balance sheet or in the footnotes. I don't see a problem with keeping my consistency of a focus on transactions as long as there is disclosure in the footnotes that is adequate. I would see no benefit of putting it on the balance sheet. **[TMKT 4/7, p. 92-93]**

Committee/Staff/Observer
We are interested in not only how you would like that information displayed but also how do you use information. If you make an adjustment to the historical information as part of your analysis, and if that is how you use information that is disclosed, then we might have an interest in imbedding that adjustment in the information itself so the adjustment doesn't have to be made. **[TMKT 4/7, p. 93]**

Participant F-5
The balance sheet is intended in my mind as I read a balance sheet to reflect liabilities but a contingent liability is not a liability it is a contingent liability. We don't know yet what the outcome would be and therefore I think it is more appropriately put in the footnotes rather than on the balance sheet. **[TMKT 4/7, p. 93]**

Participant F-4
I would feel very uncomfortable if the accounting profession were to imbed into the balance sheet [participant F-5]'s assumptions or [participant F-5]'s view of the world. I would prefer that you would imbed my view of the world which I am sure is going to be entirely different from [participant F-6]'s view of the world. **[TMKT 4/7, p. 93]**

Committee/Staff/Observer
It would be management's view of the world if we do these things. **[TMKT 4/7, p. 93-94]**

Participant F-4
But we have already talked about how much confidence we have in management. **[TMKT 4/7, p. 94]**

Committee/Staff/Observer
Well I wonder if that isn't what is really behind a lot of this. **[TMKT 4/7, p. 94]**

Participant F-4
One other question that [committee/staff/observer] sort of whispered was the term warranty reserve as a contingent liability. Loan loss reserves for a bank are a contingent liability. There are all types of contingencies and in many of the instances where there are these items on the balance sheet they have annuity-like features. You know there are going to be some losses, you know there are going to be some claims, you may not know today what the total dollar amount would be but you know it is going to happen. **[TMKT 4/7, p. 94]**

I have never met a perfect banker that has never had a loan loss. I have never met a perfect VCR manufacturer that has never had something fall apart. It makes some sense to me that there is some "contingent" knowledge that is appropriate to be in the balance sheet. I am not sure that I would give the same credence to point in time appraisals. **[TMKT 4/7, p. 94]**

Committee/Staff/Observer
So you wouldn't object to the new accounting standard on post employment benefits which is also a guess about the future. Maybe [participant F-5] wouldn't want that on the balance sheet and he prefers pay as you go. **[TMKT 4/7, p. 94-95]**

Participant F-4
I have wrestled with that point. In some respects it seems appropriate because we know there is going to be some health care costs in the future, we don't know how much that is going to be. **[TMKT 4/7, p. 95]**

One of the things that puts me on the other side of the fence is that I have a lot of problems with using discounted cash flow or the discounting mechanism to reflect some of these things. It is a little easier when you apply one discount rate to a whole class of assets but in other instances you might be applying a whole variety of discount rates to a whole variety of assets and you end up a mishmash. You are never quite sure what it really means and you approach it gingerly because you get an intuitive sense that what is there can't be independently verified. **[TMKT 4/7, p. 95]**

Committee/Staff/Observer
[Participant F-6], let me kind of close this discussion with perhaps your thoughts. I would like to move on for a minute after [participant F-6]'s observation to the third illustration and the effect that it has on inventory accounting. **[TMKT 4/7, p. 95]**

Participant F-6
One of the presumptions here, was the idea that footnotes are nice but maybe a dual balance sheet and a dual income statement were better. I think everybody recognizes that there is value to each one and there are problems when you mix market values. Where assets move frequently, cost becomes market because they are turning over so regularly. **[TMKT 4/7, p. 95-96]**

Somebody would call it transaction cost accounting because I have purchased new inventory three months ago and prices aren't moving frequently because of the economic environment. The concept that I would support is either two balance sheets or one that takes the most relevant values in a high turning asset. It is a cost type thing but in the 1906 building it really tells me nothing about the current decisions, the quality of the investment. **[TMKT 4/7, p. 96]**

You made the comment about the whole thing in investments is future value. Not future value, future cash flows. In fact there is another side to that equation. There are times where based on future cash flows companies are not purchased, but smart investors, such as in the leverage buyout days, realized that there were current values well in excess of the utilization of those assets. Therefore they purchased companies for the sole purpose of disassembling them

and realizing those current values. I wouldn't say it is just a game of future cash flows. **[TMKT 4/7, p. 96]**

It really is an understanding of both dynamics, historical cost and future cash flow as well as a series of current values. The goal is getting enough information to compare two different metrics and make some business decisions against them. No one sort of value reigns supreme. If I got handed two balance sheets and two income statements I could walk away very happy but the cost factor of preparing that is the dilemma. **[TMKT 4/7, p. 96-97]**

Committee/Staff/Observer
That was one of the points that we wanted to pursue. Is this more helpful than just having it in the footnotes where you take what is in the footnotes and try to do something similar? **[TMKT 4/7, p. 97]**

Participant F-6
I do see regularly individual analysts that are lenders who are forced to do their own analysis. They come in with the current format they make partial adjustments to segments of income statements and balance sheets that are not integrated. But it really does trouble me that I don't have a complete modification of the analysis going forward. **[TMKT 4/7, p. 97]**

Committee/Staff/Observer
Let's move on to illustration 3 on page 2. We have a comprehensive income statement. We wanted to talk a little bit about a situation where it is clear that cost of products being sold is increasing over the reporting period and under the historical model you would probably utilize a FIFO flow to determine cost of sales. The earnings before gains and losses in the historical model would be $18,000 and under the fair value using current cost the earnings would be $14,000. **[TMKT 4/7, p. 97-98]**

Is that information useful to you? Does that type of a presentation tell you something that you might not otherwise know? **[TMKT 4/7, p. 98]**

Participant F-6
One of the things that troubled me on the inventory, your holding period gain was based off ending inventory levels as opposed to the assumption, that you were using a FIFO method. If I have a core level of operating inventory. The point is that I am making or losing money on that core inventory. I have to retain a core supply of inventory and I am not sure how this one reflects this point. **[TMKT 4/7, p. 98]**

Committee/Staff/Observer
I think we took the quantity at the end of the period. **[TMKT 4/7, p. 98]**

Participant F-6
Yes but I would use the assumption that I am carrying a level of inventory which would be the lesser of the two, use the original inventory level or the ending inventory. **[TMKT 4/7, p. 98]**

Committee/Staff/Observer
Sort of base stock. **[TMKT 4/7, p. 98]**

Participant F-6
Yes, base stock. I would use the lower of the two, the core level. **[TMKT 4/7, p. 98]**

Committee/Staff/Observer
The lower of the two or average inventory level. **[TMKT 4/7, p. 98]**

Participant F-6
An argument could be made for average inventory. I would be troubled by the end of period inventory. It was irrelevant in the example here but it struck me as being not a proper reflection of what is the holding period gain/loss. **[TMKT 4/7, p. 98-99]**

Committee/Staff/Observer
More to the point. What to you think about trying to have an alternative measurement of gross profit? **[TMKT 4/7, p. 99]**

Participant F-6
Because of the turn cycle in inventory I didn't see it as important as things like investment in the real estate or the plant and equipment. These are longer term business capital budgeting decisions. Buy/sell/hold decisions. You don't make buy/sell/hold on inventory. You are in the business of managing your inventory. **[TMKT 4/7, p. 99]**

Committee/Staff/Observer
It did have a 10% impact in this case. **[TMKT 4/7, p. 99]**

Participant F-6
Well it did but I mean the company still earned it. It is a holding period gain but I assume that is a normalized item. I am going to continually hold inventory so that while it may have a cost me, it may have earned me money this period because prices are up. But if I assume there is a commodity nature to it. It is either going to be a business where there generally is inflation or it is technology where there is a convenient decline in sort of raw material costs or parts cost. Or it is a commodity business where it is going to be up or down over a period of time and that should normalize itself out. **[TMKT 4/7, p. 99-100]**

Committee/Staff/Observer
The example is simplistic but we are just trying to get to determine whether or not the information is useful. **[TMKT 4/7, p. 100]**

Participant F-2
I guess I have more problems with inventory accounting in general LIFO, FIFO. They give you a completely different result, probably even greater than this particular example. If the company in this example had been using FIFO and another was using LIFO the difference

would probably be greater than the fair value changes method you are showing here. This is outside of this realm but I would much rather see one standard method of accounting for inventory. **[TMKT 4/7, p. 100]**

Participant F-6
Wouldn't this somewhat normalize between the two though, I mean this method. **[TMKT 4/7, p. 100]**

Committee/Staff/Observer
Between LIFO and FIFO. **[TMKT 4/7, p. 100]**

Participant F-6
Right. Well you still have the holding period factor. **[TMKT 4/7, p. 100]**

Committee/Staff/Observer
The income statement has an increase in price scenario closer to LIFO, but the opposite effect on the balance sheet. **[TMKT 4/7, p. 100]**

Participant F-6
Right so it sort of normalizes the two of them. **[TMKT 4/7, p. 100-101]**

Participant F-3
This is getting off track a little bit and it may be a dumb question but why wouldn't you apply a discount factor to accounts receivable? It seems to me that it is pretty easy to look at that asset or that pool of assets or liabilities and say that is due over a certain period and apply a discount factor. You need to do that for consistency. That value will change over time due to among other things changes in the interest rate. If you are going to affect the balance sheet with information such as changes in interest rates such as its affect on long term debt. You ought to follow through and do that to assets as well. **[TMKT 4/7, p. 101]**

Committee/Staff/Observer
My sense is conceptually there isn't a good argument against not doing. Practically, some would argue that it may not be worth the effort on a cost benefit assessment bases, but conceptually I would certainly see your side of any debate. **[TMKT 4/7, p. 101]**

Anything else with respect to the manufacturer? Should we turn to the financial institution? **[TMKT 4/7, p. 101]**

Committee/Staff/Observer
I just want to be sure where we are. Just going down the assets and liabilities in terms of disclosure of value information, if we could just do a quick consensus or vote on where you would like to see value information in terms of a manufacturing entity. Cash is probably a

non-issue. I heard [participant F-3] express some interest in receivables. **[TMKT 4/7, p. 101-102]**

Committee/Staff/Observer
Let me try and back up a minute. My sense is that if you were going to value information, [participant F-3], you thought it would be inappropriate or internally inconsistent not to focus on receivables. But what I was hearing everybody say is that the preference is for illustration 1 and clearly for historical cost of all assets and liabilities with perhaps some exception in land held for sale and investments if they are not part of the normal operating assets and liabilities. Then there was a range of views between historical cost with some disclosures or fair value with some disclosures. **[TMKT 4/7, p. 102]**

Participant F-6
I would go even a little further and say non-operating assets. Something like cash we will find in certain companies right now significant amounts of non-operating and non-working cash that are invested and that those should be considered. I mean there is a need to separate out the non-operating components of the balance sheet and I would say this is a company in particular that has a large level of cash relative to its total assets. **[TMKT 4/7, p. 102]**

Committee/Staff/Observer
I didn't mean to cut you short but that is what I gleamed from it. [Committee/staff/observer], if that doesn't answer your question please pursue. **[TMKT 4/7, p. 102-103]**

Committee/Staff/Observer
Well I guess [participant F-3] has raised this issue. I think [participant F-6] expressed that maybe there might be a benefit of having two columns. I think your thinking was that it would have to be both sides of the balance sheet, leaving the historical columns essentially intact. **[TMKT 4/7, p. 103]**

Participant F-3
I like the historical column. I like the additional information in a footnote for example but again I think if you are going to show the effect of interest rates on some part of the balance sheet you should follow through on both sides. **[TMKT 4/7, p. 103]**

Committee/Staff/Observer
If we were to have fair value disclosure either in the format of a supplemental set of financial statements or otherwise for a manufacturing company would you carry that fair value to property plant equipment used in the business as the illustration 2 and 3 have? Even from a disclosure point of view. **[TMKT 4/7, p. 103]**

Participant F-6
If I could get a whole balance sheet I would take the whole thing, operating and non-operating. But as far as mixing them together if it was a one balance sheet mixed together I would separate operating from non-operating. **[TMKT 4/7, p. 103]**

Committee/Staff/Observer
We will continue with historical cost as we always have, and now we are talking about some form of supplemental disclosures which might take the form of supplemental financial information. **[TMKT 4/7, p. 103-104]**

Committee/Staff/Observer
My sense for clarity is that is not what I heard. If there was a move toward value don't ever value operating assets and liabilities. If you value operating assets and liabilities value the whole balance sheet and present it as supplemental disclosure. If there is some presentation that combines value and cost the disaggregation or the focal point should come between operating and non-operating. **[TMKT 4/7, p. 104]**

Participant F-6
Right. **[TMKT 4/7, p. 104]**

Committee/Staff/Observer
Most people who speak about financial institutions say that they want to have value information. If you are going to present it, you must present both sides of the balance sheet. In illustration 1, we have value type information for investments available for sale and loans held for sale. The liability side of the balance sheet deposits and long term debt are also at value. **[TMKT 4/7, p. 104]**

The only difference between Illustration I and illustration 2 is that we expanded the same value concept to other investments and loans that weren't held for sale and make it more all-inclusive. We've talked about this morning, but I just want to get your reaction: Does the bank illustration, tell you something or is it more meaningful than maybe the manufacturer model might have been? **[TMKT 4/7, p. 104-105]**

Participant F-1
I'm not a financial company expert and I'm prepared to listen to arguments that fair value presentation is more significant for financial businesses. I would emphasize what I think the other folks here would support, is that under no circumstances do I think that it that should be in lieu of historical cost. **[TMKT 4/7, p. 105]**

Participant F-2
I look at these companies from the credit perspective. I definitely don't want to lose historical data because you're going to be paying the debt off at values that are on the books. Rates

move from 10% to 6%. You're not going to be paying off 4 1/2 times what the debt was on the books. You've got to service the debt at x dollars. **[TMKT 4/7, p. 105]**

I think there's some additional information you can get by looking at fair value that would be helpful. But I sure don't want to lose the historical stuff because I think a lot of what you're doing here is geared more toward the equity analysts -- people trying to evaluate where the stock is. **[TMKT 4/7, p. 105]**

Committee/Staff/Observer
On that one point though do you feel the same way about trading portfolio? **[TMKT 4/7, p. 105]**

Participant F-2
Oh no. I think there is some information that is worthwhile by valuing the whole balance -- not looking at the whole balance sheet at current fair values can be somewhat misleading. **[TMKT 4/7, p. 106]**

Participant F-6
I hate to be a panelist take a liability. I've have a fixed rate long-term debt. In many cases the call premium is what is of relevance to you. That's my pay-off value. **[TMKT 4/7, p. 106]**

Participant F-2
I'm looking at trying to service the liability side. **[TMKT 4/7, p. 106]**

Participant F-6
Right. I'm talking about the liability side. I've got long-term debt. I'm a bank. You've got a long-term debt instrument that was issued at 9 1/2. Rates are now 6. I've got a pre-payment, a call provision at 103. One hundred has nothing to do with it. I might actually issue it at 98.65 and yet you tell me you want cost. We don't show those on our balance. We show them at par. We don't show them at cost. **[TMKT 4/7, p. 106]**

And then the other side is that you've got a premium. I think some people are using cost value as a liquidation value analysis and that on the liability side it isn't in fact the case. It all depends. There's a determination to be made if rates are at 6 and it's highly likely at the first call date that I'm going to pre-pay the obligation then the 103 is the relevant value. **[TMKT 4/7, p. 106]**

Participant F-2
I've seen a ton of that in financial institutions. Over the last couple of years there have been a lot of early calls. **[TMKT 4/7, p. 107]**

Participant F-6
Right. **[TMKT 4/7, p. 107]**

Participant F-2
I guess my point is that with the value going from 10% to 6%, you would have a much higher inflated value than the call price would probably be. **[TMKT 4/7, p. 107]**

Participant F-6
Right. You'd have a value of 115 but your liquidation cost would be 103, which is your call premium. I just heard you say that cost is what it liquidates at. There are assets out there that liquidate different than par value or cost. **[TMKT 4/7, p. 107]**

Participant F-4
One of the problems I have with this whole presentation is that there's an awful lot of matched lending going on out there. You may have 18% credit card receivables. So you've got these 18% credit card loans matched off against funding that may have occurred 3 years ago or 4 years ago at maybe 8 or 9% so that there's a form of locking. **[TMKT 4/7, p. 107]**

There's also some annuity characteristics being applied to that credit card debt. It's not a perfect match, but this analysis in my view doesn't really take any of that into account. **[TMKT 4/7, p. 107]**

There's a whole lot of zeroes on the liability side of the balance sheet, you know demand deposits have a different value, in different interest rate environments. Savings deposits have a different value in different interest rate environments. And I guess I had a real problem with using CDs here. I kind of figured you were looking at consumer CDs, because with large negotiable CDs you're not going to see that kind of value changes. **[TMKT 4/7, p. 108]**

If you're going to apply that kind of value changes to CDs, it sure makes sense to do the same thing with savings accounts. **[TMKT 4/7, p. 108]**

Participant F-6
You can have brokered CDs. **[TMKT 4/7, p. 108]**

Participant F-3
Yes, you might well have term CDs. I think that to the extent that most of us feel, this should be supplemental information. I'd rather see more of it than less. One of my complaints, certainly with illustration 1, is this distinction between held to maturity and available for sale. **[TMKT 4/7, p. 108]**

Committee/Staff/Observer
That's one of the points I want to understand. I mean is that a workable criteria? **[TMKT 4/7, p. 108]**

Participant F-3
I don't see how you divide an investment portfolio that way. I know you can come up with a rule but I think you know for all intents and purposes, it's all securities, it's all the same type of security. I also think unfortunately that this is increasingly true of the loan portfolio as well. It is all subject to sale, to greater or lesser extent. And I think distinction between held for sale and held to maturity gives management an opportunity to play with the numbers, because you know it's a management judgment as to whether we're holding it for sale or not. **[TMKT 4/7, p. 108-109]**

Participant F-6
I would say that the science particularly as it relates to loans is not there yet. We go through regular debates about what are the values of the loan. And I would argue that the idea that whether it's investment securities -- with publicly traded investment securities. I don't have a problem. But there's a lot of non-traded assets in those held to maturity categories similar to loans, IRBs and so forth. If we're going to do it it needs to be the whole thing because of the integrated nature of the way the balance sheet works. This includes on and off balance sheet items. Somebody said contingent. I would say off balance sheet in many cases is not contingent. They just don't have cash settlement options. It's more a notion of principle of underlying swap contracts. But that whole thing needs to be pulled together. **[TMKT 4/7, p. 109]**

But then there are other pieces out there. I think core deposit intangibles is easier to quantify than loan value. This whole loan impairment thing is selecting small pieces of a portfolio. We're actually getting to the point we're making some real nice spreads and we have some impaired loans. You look at distressed loan prices out there. Some people are actually bidding up some distressed loans recently. Because they typically have higher yields. The flight is away from quality, chasing yields right now has driven those things back up in value on a relative basis. **[TMKT 4/7, p. 110]**

Committee/Staff/Observer
Page four. Doesn't the number in the middle of the page tell you something. It says sub-total value changes. And essentially what that is is your investments and loans at market value and assuming that we took all our liabilities that were funding those investments at market, wouldn't that $5,000 not give you a sense as to whether or not the assets and liabilities are matched? **[TMKT 4/7, p. 110]**

Participant F-4
It could. But I think I'm already given that information, looking at the trend in interest margin. I like getting the average balance sheets because that gives me a lot of information. I've actually gone through this exercise, of going through all the assets, and all the liabilities, and making some estimates. It is a lengthy, grueling, horrible experience, and when you come out at the end you discover that regardless of whether you throw the prime up to 20% or take

it down to 4%, that there's a lot of offsets. I mean the final differentials that you come up are not nearly as great as you would've expected. It's surprising and astounding. **[TMKT 4/7, p. 110-111]**

Committee/Staff/Observer
Is that in all institutions? Or is that the ones you're following, which are of higher quality. **[TMKT 4/7, p. 111]**

Participant F-4
I've done it only for a couple, because it is such an enormous amount of work. But, and mostly larger institutions. I get really bothered by this but this whole notion of this held for sale versus trading? I come back to this notion that there's a cyclical retooling that is sort of like a natural cycle in the banking business. At one point in the economic cycle you make loans. At another point you own securities. **[TMKT 4/7, p. 111]**

There's a huge differential between the [Company A] and the [Company B]. [Company B] serves an economic value in that community. And the kinds of things that we're talking about here would probably create economic incentives or disincentives that may or may not be intended as to how that [Company B] operates. **[TMKT 4/7, p. 111-112]**

Especially when you come down and say it's held for sale and say it is trading. I think this is something that really deserves some consideration because if we go to this full fair-value the thought has occurred to me that the purpose of fair-value accounting is to drive out the small banks and thrifts in this country. Drive them out of business because I think that would be the economic effect of this kind of accounting, because of the cost. That needs to be a consideration. There are banks that still operate under traditionally loans at one point, securities at another. **[TMKT 4/7, p. 112]**

There's an economic impact here that we haven't really talked about. **[TMKT 4/7, p. 112]**

Committee/Staff/Observer
Don't you think that banks, even the [name deleted], manages its assets or portfolio of securities, whether held for investment or held to maturity or otherwise on the basis of some evaluation of market value? **[TMKT 4/7, p. 112]**

Participant F-4
There will always be some element of that. I would think. But I'll tell you, the [name deleted] is playing gunslinger with their investment portfolio. I wouldn't want to own it anyway. **[TMKT 4/7, p. 112]**

Committee/Staff/Observer
I didn't mean to imply that they were gains trading. But rather that just legitimately managing their investment portfolio. They need to do so in light of knowing what the current market values are at any one point in time. I buy into your cost concerns. **[TMKT 4/7, p. 113]**

Participant F-6
I'm less concerned about the investment portfolio because we're dealing with fixed contract type things with very tight control. But in the negotiated loan market the science isn't there. **[TMKT 4/7, p. 113]**

I think the biggest component in all of this is the option nature of so many loans, the ability to pre-pay a loan. I know it's obviously a simplistic discussion -- but the struggle for everyone is how do you deal with these options. **[TMKT 4/7, p. 113]**

We are not at that point with the loan portfolio, and in fact, there's more in terms of options than there could be in the Treasury portfolio. Pre-payments are so significant that I get concerned that we would come back and try to present a loan value. You said doesn't it tell you something when a $5 million change in the value of the balance sheet occurs? Yes. And the way the income statement is set up now, if a bank earned $10 million and the margins stayed relatively consistent in the marketplace, I'm expecting they would have net interest income of about a similar level next year. The real wild card is asset quality. This value number could confuse the me because I don't know next year how sensitive they are with all these embedded options, running through the whole portfolio. **[TMKT 4/7, p. 113-114]**

This could easily turn in the opposite direction. A shift in the yield curve, short and long, could destroy this thing. It would tell me less. It's not harmful from a balance sheet perspective but the income statement really tells me even a lot less than what I have today. It takes away some of the things that I can take some comfort in. **[TMKT 4/7, p. 114]**

Participant F-3
I was going to say that I agree absolutely that I see potentially a lot of value in supplemental information to the balance sheet, but because of the volatility of the markets and the values, I have a hard time looking at the income statement, saying well this was my change during this period. **[TMKT 4/7, p. 114]**

Coming back to [the one company] example, what if the value of [another company's] stock drops from $1 billion to $500 million, then we're going to say, they lost money last year. That really isn't part of the discussion we should have or their management should have. **[TMKT 4/7, p. 114]**

Participant F-2
Okay, well I guess mine wasn't so far afield. The volatility I think of the earnings statement certainly would increase under a fair-value accounting. I think we're starting to see a lot of

that just with the securities held at market out there for resale. And I had a conversation yesterday with a CFO, who said a suggestion was brought to him to do a transaction purely for accounting purposes and that it really wasn't economic. **[TMKT 4/7, p. 115]**

The more I thought about it; they didn't do it, but the more I thought about it the more it disturbed me. Maybe more and more of that is going on in the industry, and from a credit perspective that concerns me. **[TMKT 4/7, p. 115]**

Committee/Staff/Observer
But if we had fair value information like this, maybe you couldn't do those transactions. **[TMKT 4/7, p. 115]**

Participant F-2
Well this was in a portfolio that was held for sale. **[TMKT 4/7, p. 115]**

Committee/Staff/Observer
Well what we're trying to illustrate on page four of illustration 2, is that in the top half of the statement you have earnings before value changes. You have exactly the information you had before. And all of the rest really is supplemental even though it might be embedded in comprehensive income. Yet, a couple of you said you lose information that you've had before. **[TMKT 4/7, p. 115-116]**

Participant F-2
No, I'm not afraid of losing information. I like additional information. **[TMKT 4/7, p. 116]**

Participant F-3
But in a sense you gain data and to me this data is noise as much as anything. **[TMKT 4/7, p. 116]**

Committee/Staff/Observer
It's not information. It's not useful. **[TMKT 4/7, p. 116]**

Participant F-3
It is something else I have to spend time on and maybe the board spends time discussing why it occurred. **[TMKT 4/7, p. 116]**

Participant F-4
The other question I would have is something I think you all on that side of the table remind us of periodically, is that professional analysts are not the only ones who look at these statements. **[TMKT 4/7, p. 116]**

I sit and think about what would be the impact on someone like my mother, who never went to college. Just an ordinary Main Street type woman and she had an investment in this illustrative bank and she sees the 465 and then she sees the 1650 and says, wow I've got to own this thing. She sees 465, or the next year, she sees 465 minus 20. She says oh my God. I think another question that needs to be looked at is the potential economic impact on some aspects of the industry. All of us at this table have focused on banking, and lots of the proponents of fair-value accounting have focused on banking. **[TMKT 4/7, p. 116-117]**

But I'd be real curious to know what the impact would have been on [one company] if things that were really loans had been classified as loans a few years back. Or [another company]. Or some of these other financial companies. I would also be very concerned about what the insurance industry would look like, because there's an industry that really thinks in terms of a 30-year horizon. That's their purpose and I would just wonder if that wouldn't create havoc that might be socially and politically unexpected. I think you're getting into a whole different set of issues. **[TMKT 4/7, p. 117]**

Participant F-3
But it shouldn't be. I mean if the insurance company is matched and if you take this supplemental information, follow it all the way through, and you establish the value today of the assets, and then you do the same thing for the insurance liability. Don't you or shouldn't you come out with a net value close to zero? **[TMKT 4/7, p. 117]**

Participant F-4
Yes. If all assets and all liabilities are being taken into consideration. One of the problems all of us have had, with the examples we're seeing, and in what we're hearing out there in the so-called real world, is that only a portion of the income statement, the balance sheets in particular, would be subjected to this fair value. I find that very disturbing. **[TMKT 4/7, p. 117-118]**

Participant F-2
Just look at this example here. You get two completely different answers on where the equity should be, what you report as fair value. In the first example you get less equity, and the second one you get twice as much. **[TMKT 4/7, p. 118]**

Committee/Staff/Observer
We didn't mean to infer that you would just pick and choose. We were just trying to get your reaction. **[TMKT 4/7, p. 118]**

Participant F-2
No. But values are different. **[TMKT 4/7, p. 118]**

Participant F-4
But I guess my feeling is that there is a lot of dispersion here that I find unacceptable. **[TMKT 4/7, p. 118]**

Committee/Staff/Observer
Let me wrap up by trying to articulate what I've heard as a result of our discussions on the illustrations. Then we can spend a couple of minutes trying to clarify these points. **[TMKT 4/7, p. 118]**

There is some interest in fair value information if it is complete, and the fair value information that would be presented, not as a substitute for, but would be in addition to the historical cost information. **[TMKT 4/7, p. 118-119]**

If a single set of financial statements was used there is some interest in a slight extension of today's mixed attribute model. That extension would be either through accounting on the face of the income statement with disclosure or with disclosures. **[TMKT 4/7, p. 119]**

That's what I have heard based on our discussion of the illustrations which supplements what we agreed was a summarization of your views before we got into the illustrations. Fair? Need modification? Totally in left field? Silence is agreement? **[TMKT 4/7, p. 119]**

Participant F-3
Fair. **[TMKT 4/7, p. 119]**

Participant F-2
From my standpoint also. **[TMKT 4/7, p. 119]**

4.147

A substantial 72% of all those interviewed say they are familiar with the work of the FASB in formulating a conceptual framework for financial accounting and reporting.

Table 4.1

FAMILIARITY WITH THE CONCEPTUAL FRAMEWORK

Q.12F—Do you feel familiar or unfamiliar with the work of the FASB in formulating a conceptual framework for financial accounting and reporting?

		Large Public Companies		Small Public Companies	Private Companies			Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	C. E. O.	C. E. O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Familiar	72	85	80	61	68	46	51	87	93	73	93	61	97	65
Unfamiliar	25	15	16	30	21	51	44	13	7	27	7	35	3	35
Not sure	3	–	4	9	11	2	5	–	–	–	–	3	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

In the course of this study, a number of the key aspects of the conceptual framework efforts of the FASB were asked about.

Reaction to Concepts Statement 5

Two key matters regarding Concepts Statement 5 were tested. First, each person surveyed was asked about the current practice of having items reported in financial statements measured by different attributes:

Table 4.2

REACTION TOWARD CONTINUING CURRENT PRACTICE UNDER WHICH ITEMS REPORTED IN FINANCIAL STATEMENTS ARE MEASURED BY DIFFERENT ATTRIBUTES

Q.13A—In Concepts Statement 5, the Board noted that items reported in financial statements now are measured by different attributes, principally historical cost, but also including in some circumstances current market value, net realizable value, and present value of future cash flows, depending on the nature of the item and the relevance and reliability of the attribute measured. In Concepts Statement 5, the Board also says it expects this approach to continue. Do you feel that position is wise or unwise?

	Total Sample
	%
Wise to continue approach	82
Unwise to continue	12
Not sure	6

Observation: *Obviously, the approach spelled out in Concepts Statement 5 on the use of different attributes in measurement receives a hearty endorsement.*

[HARRIS]

4.148 Following is a breakdown by respondents on the reaction toward continuing current practice of the use of different attributes for measurement.

Table 4.3

REACTION TOWARD CONTINUING CURRENT PRACTICES: BREAKDOWN BY RESPONDENTS

		Large Public Companies		C.E.O.				Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Wise	82	82	82	79	86	71	84	73	80	60	80	87	95	76
Unwise	12	10	16	12	7	20	13	16	13	20	13	3	5	18
Not sure	6	6	1	9	7	10	3	11	7	20	7	10	–	–
No answer	*	1	–	–	–	–	–	–	–	–	–	–	–	6

*Less than .5%.

The second issue of information based on current prices being recognized if it is sufficiently relevant and reliable to justify the costs involved and is more relevant than alternative information receives a more mixed reaction, although a substantial majority views it as a wise provision as outlined in Concepts Statement 5.

Table 4.4

RECOGNITION OF CURRENT PRICES

Q.13B—In Concepts Statement 5, the Board says that information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and is more relevant than alternative information. Do you feel that position is wise or unwise?

		Large Public Companies		C.E.O.				Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies	Private Companies	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Wise	65	47	56	70	64	76	74	64	73	53	67	61	84	94
Unwise	28	44	41	18	36	15	21	29	20	33	33	26	11	6
Not sure	6	6	4	12	–	10	5	7	7	13	–	13	5	–
No answer	*	3	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

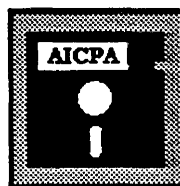
Observation: *Although the current prices issue meets with general approval the way it is dealt with in Concepts Statement 5, substantial minorities in the corporate world, particularly among CEOs and CFOs of large public companies, have reservations about it. However, they are a distinct minority view.*

[HARRIS]

5. Display

Data Base Code	
SRI	□
RMA90	■
RMA92	■
FASOversight	■
AIMR/CIC90	□
AIMR/CIC91	■
AIMR/CIC92	■
AIMR/FAF91	■
AIMR FIN SER INDUSTRY	■
AIMR/FAPC92	■
LYNCH	□
KPMG BANK STUDY	■
BEAR STEARNS	■
GOLDMAN	■
FREEDMAN	□
PREVITS	■
HILL KNOWLTON	□
TOWERS PERRIN	□

Data Base Code	
S&P	■
BETRIOU	■
R.G. ASSOCIATES	□
HARRIS	■
TI 10/16	■
PMQI 10/16	□
TI 12/9	■
PMQI 12/9 and 1/13	■
TI 1/13	■
TI 3/17	■
PMQI 3/17	■
TC 12/8	■
PMQC 12/8	□
TC 2/2	■
PMQC 2/2	□
TC 3/11	■
PMQC 3/11	■
TMKT 4/7	□



5(a). Income Statement, including Core Earnings and Comprehensive Income

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to criticisms of financial reporting. . . . **[FASOversight, p. 1]**

- The conceptual focus on the balance sheet results in confusion in the income statement. It is difficult to identify "operating income before nonrecurring events," which is an important basis for assessing expected future cash flows. **[FASOversight, p. 2]**

Consideration of Reporting Unusual or Infrequent Events [following 6 paragraphs]: Our lender participants declined to criticize or suggest changes in the standards of financial reporting in effect today, although some felt that these standards often are not implemented well or in good faith. Rather than attempting to state what the accounting standards should be, our members expressed themselves more in terms of what type of information they required and how they used it. A summary of those remarks follows. **[RMA92, p. 1]**

First of all, bankers look for income to be reported on the income statement and to be displayed in a good amount of detail. Therefore, items carried directly to equity (thus bypassing the income statement) should be the exception rather than the rule. They would be confined to the correction of outright errors made in prior years and the cumulative retroactive effect of certain changes in accounting principles. The idea is that it is better to have an item on the income statement in the wrong period rather than not have it there at all. Both types of restatement of the past must be accompanied by full disclosure to enable users to revise prior years' amounts carried in their databases. **[RMA92, p. 1-2]**

The use of the term and category "extraordinary item" is unfortunate. Bankers want to be able to consider separately each item affecting income that can be considered either unusual in character or nonrecurring or both. Bankers, together with most financial statement users, are "future oriented." They use data from current financial statements as a means of estimating what earnings statement items will: (1) persist in the future, and (2) result in cash inflows either in the current period or within the near future. Unusual and nonrecurring items usually fail one or both of those two tests. We do believe that disclosure of all such items should be required, not merely permitted. Furthermore, the tax effects of each such item should be disclosed, although we are indifferent as to whether or not intraperiod income tax allocation procedures need be followed on the income statement. Obviously, it is important to establish materiality thresholds for such disclosures. **[RMA92, p. 2]**

The separate disclosure of discontinued operations is essential to credit analysis. First, lenders focus on ongoing operations for trend analysis and projections of future cash flows. We look at discontinuances of operations and other asset disposals as changing the financial position of the company and its availability for loan repayment. Discontinued operations may have weakened a company; it's the ongoing ones that will pay us back. **[RMA92, p. 2]**

Changes in accounting estimates should be effected without restatement of the past. However, it is vital, for all the reasons given above, that their effect on both the financial position of the enterprise and its earnings for current and future periods be disclosed clearly. **[RMA92, p. 2]**

[L]egalistic approaches to financial reporting seem to impede rather than facilitate communication of financial information. We suggested a private companies version of the Management Discussion and Analysis (MD&A) required of public companies by the SEC. Lenders need to understand their customers' businesses, a necessity best met by open and good faith explanations of the business by the customer and his or her accountant, either in writing or verbally. [Also included in 10(b) and final sentence also included in 13] **[RMA92, p. 2]**

The APC [Accounting Policy Committee] has considered and expresses below its opinions on a number of specific issues affecting financial accounting standards and financial reports. The APC believes that the following items should be included in the single body of accounting concepts, standards, principles and methods: **[RMA90, p. 5]**

- The income statement and balance sheet should be prepared under the principles of accrual accounting. The income statement should reflect economic events of the current period by matching to the accomplishments of that period (revenue), the efforts necessary to achieve them (expense). The balance sheet should reflect the cumulative effect of that matching process. Accruals and deferrals are necessary for proper matching to occur, and by their nature deferrals, which require allocations, and accruals, which require estimates of future expenditures, are arbitrary and imprecise. Therefore, care must be taken to see that their use not be extended to permit "normalization" of earnings in any accounting period, annual or interim. Normalization, like forecasts and projections, is the province of the financial statement user and should not be incorporated into financial reporting. [Also partly included in 2(b)] **[RMA90, p. 5-6]**

- The APC [Accounting Policy Committee] favors an all-inclusive income statement. Net income should include the effect of <u>all</u> of the current period's economic transactions and other activity of the entity. Retained earnings should be increased by earnings/(losses) and decreased only by distributions to owners of the company. The only other adjustments that should be made to retained earnings are: (1) correction(s) of material error(s) in the computation of income of previous periods, and (2) the cumulative retroactive effect of a change in accounting principles. In both of those circumstances, information should be provided to allow restatement of individual prior years' income for purposes of comparison to the income of the current and future years. **[RMA90, p. 6]**

- Within an all-inclusive income statement and in supplementary disclosures the APC [Accounting Policy Committee] recommends extensive disclosure of the composition of income. Lenders require detail in order to assess the quality of earnings and to make intelligent comparisons both among different enterprises and over time for a single entity. Important disclosures include all of the following: **[RMA90, p. 6]**

  a. Separate reporting of the results of: (1) continuing operations, (2) discontinued operations, (3) extraordinary items, and (4) retroactive effects of changes in accounting principle. Each of the four categories should conform to GAAP standards, and each should be shown both before and after its impact on the period's income tax provision (credit). **[RMA90, p. 6]**

  b. Items that affect the reported results of continuing operations, but which management considers to be unusual or nonrecurring, should be identified clearly with supplementary information discussion. **[RMA90, p. 6]**

  c. Within continuing operations, the enterprise should disclose each major source of revenues (product sales, services, financing of customers, etc.), expenses by function (cost of sales, selling, administration, etc.), and within functions by object of expenditure (wages, utilities, etc.). The company should disclose the methods it uses to recognize revenue, amortize costs, and to record significant accruals and deferrals. **[RMA90, p. 6-7]**

[Equity sell-side] analysts employ a literal definition of nonrecurring income statement items, which are usually referred to as "one time" items. They take notice of reported nonrecurring items as listed below continuing operations and also note the effect of new accounting rules. One report contained a section entitled "Non-operating earnings - A Source of Confusion in the Past". [Also included in 1(b), 1(c), and 5(d)] **[PREVITS, p. 15]**

[Equity sell-side analysts] also identify "potential" nonrecurring items contained in continuing operations, and often report EPS net of these items, as in the case of the analyst who noted "several unusual items" included in continuing operations. Correspondingly, a number of analysts report operating earnings per share, which of course is not required under GAAP, or compute an "adjusted earnings" number which includes all items judged to be nonrecurring, and corresponding EPS. Restructuring charges are an example of one common item often removed in analysts EPS reports. Occasionally analysts identify a nonrecurring cost but are unable to estimate an amount. In one case an analyst was unable to determine the amount of a corporate relocation charge buried in continuing operations. In another report the relocation charge of the company was identified in continuing operations and removed in calculating EPS. [Also included in 1(b), 1(c), and 5(d)] **[PREVITS, p. 15-16]**

[Equity sell-side] analysts define "earnings quality" differently than [was] expected. To financial analysts, a company with high earnings quality is one that uses very conservative accounting principles; for instance a company that has accrued reserves against future losses, write downs, etc. One analyst, for instance, reported earnings quality as high when a firm had an "aggressive" policy towards establishing reserves. Another substantiated an assertion of

high earnings quality for a company by stating that "the company is over-accruing foreign taxes as a way of managing earnings." A third supported its assertion of high quality earnings by noting that "the opportunity to 'manage down' earnings exists". A fourth argued that a financial company's earnings were more 'credible' because the company applied "more aggressive accounting" methods in writing down assets. [Also included in 1(b) and 1(c)] **[PREVITS, p. 16]**

This suggests a possible analyst preference for secret reserves. [Also included in 1(b) and 1(c)] **[PREVITS, p. 16]**

[Sometimes,] earnings quality . . . seem[s] to be related to "representational faithfulness," and management's forthrightness in disclosure. For example, one analyst reported that an extreme drop in the reported tax rate of a company "caused some to doubt the quality of (its) earnings". Another expressed concern about earnings quality on the basis of the amount of costs included by a company in the determination of cost of goods sold. [Also included in 1(b), 1(c), and 2(b)] **[PREVITS, p. 16]**

Other income analysis factors:
- Analysts see a "strategic acquisition" to be one which reduces a company's short term earnings but increases longer term earning potential.
- Analysts report sale backlog (at company or operating unit levels) and use these as a basis for estimating future performance.
- Average tax rates are calculated for most companies with income data on a comparative and trend basis. Current and deferred portions of income tax expense are often disclosed.
- Regulated companies reported "statutory" or regulatory income compared with GAAP income. [Also included in 1(b) and 1(c)] **[PREVITS, p. 16]**

Effect of Market Value Changes on Income

No matter how well mark-to-market accounting could be implemented and applied judiciously to matched assets and liabilities, it still would increase significantly the volatility of reported earnings. Some argue that the volatility exists and that a primary benefit of mark-to-market accounting is that real volatility would be revealed. Even if we concede that point, the question becomes one of how business enterprises and the capital markets are to deal with it. [Also included in 4] **[AIMR/FAPC92, p. 28]**

As financial reporting is practiced today, financial managers have much discretion over the recognition of changes in value by astute timing of exchange transactions and by the adoption of artful allocation procedures. Mark-to-market accounting would take away much of that discretion. Even where the relative influence of market value changes is small overall, at the margin it has the propensity to make earnings exceedingly unpredictable, a disconcerting fact for enterprises trying to minimize their capital costs by reporting smooth and growing earnings. [Also included in 4] **[AIMR/FAPC92, p. 28]**

Some analysts are quite willing to accept the increases in reported income volatility that would be produced under mark-to-market accounting. Many of them even would welcome it. They feel that the effects on a particular enterprise of general economic conditions and financial

market movements are relevant and to some degree vital to their assessments of its economic status and progress over time. They may not yet be ready to do away with historic cost entirely, but they look forward to the opportunity of integrating FAS 107 data into their evaluations and forecasts as soon as they become generally available. [Also included in 4] **[AIMR/FAPC92, p. 28]**

One method for dealing with changing market values and their effect on income would be for the FASB to generate accounting standards that put into practice the concept of comprehensive income that appears in Concepts Statement No. 6. As defined in Paragraphs 73-77 of that statement, comprehensive income would encompass all changes in owners' equity exclusive of transactions with owners themselves. It would also be disaggregated into a variety of basic components and intermediate components. Thus the effect of exogenous events such as market value changes would be separated from the effect of endogenous productive activities. If market value changes were reported separately and clearly, their effect isolated, then their unpredictability would assume a lesser importance as it was assessed separately from productive activities. [Also included in 4] **[AIMR/FAPC92, p. 28]**

One might ask whether a goodwill write-off should appear on the income statement or go directly to owners' equity. Regardless of the answer, a more appropriate question is where on the income statement or where in the owner's equity section it should emerge. We believe that it should appear on the income statement as part of comprehensive income and that this is another instance that illustrates the need for the FASB to develop standards for reporting comprehensive income. Cumulative amounts of goodwill write-offs also should be reported as a separate component of shareholders' equity together with complete disclosure of the changes in those amounts during each of the periods covered by the financial report. [Also included in 7(a)] **[AIMR/FAPC92, p. 31]**

[Context] The following brief summary of the topic "Income and Cash Flow Statements," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Throughout the report, there are repeated recommendations that the FASB needs to develop its concept of "comprehensive income." Much of this section of the report is devoted to integrating those references and explaining in much greater detail all the reasons why that development is needed and how it should proceed. [Also included in 5(c)] **[AIMR/FAPC92, p. ix]**

The other part of this section deals with the cash flow statement. Most financial analysts were pleased with the issuance of *FAS 95*, which requires that a cash flow statement replace the less useful statement of changes in financial position. They are not pleased with the quality of information contained in many of the cash flow statements they currently receive. First, virtually no companies have chosen to present cash flows from operations on the direct method. Failure to do so has been accompanied by arguments that are unconvincing because they are contradictory. Second, because so many cash flow statements contain detectable

errors, we call for establishment of an authoritative literature on cash flow statement preparation. [Also included in 5(c)] **[AIMR/FAPC92, p. ix]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

Over the span of the FASB's existence, its pronouncements have become more and more oriented to the statement of financial position. This is meant as an observation, not criticism. [Also included in 5(b) and 5(c)] **[AIMR/FAPC92, p. 41]**

Perhaps the most apt example is FAS 109, "Accounting for Income Taxes." It fixes its attention on identifying at a point in time those transactions and events that are deemed to have future tax consequences, then measuring the effect on financial position of the benefit(s) and/or obligation(s) resulting from them. Their effect on periodic income is calculated only as the necessary consequence of those financial position assessments. This is an approach opposite from the now-superseded Accounting Principles Board Opinion 11 in which the objective was to measure the deferred portion of the current period's provision for income taxes, with resultant balance sheet residuals called deferred tax liabilities and/or assets. [Also included in 5(b) and 5(c)] **[AIMR/FAPC92, p. 41]**

We applaud the efforts and accomplishments of the FASB in making balance sheet amounts more meaningful than before. Prior to FAS 109 (and its short-lived predecessor, FAS 96), deferred tax accounts on the balance sheet had little meaning since they were remnants of past income statements, whereas today they depict amounts that the enterprise expects to result in future cash flows. However, as FAS 109 and various other standards have been promulgated we feel that the development of the income statement has been neglected. We also feel as if more could be done to make cash flow statements more accurate and more useful to analysts. The purpose of this short section is to summarize our views on those matters: (a) with respect to the income statement, primarily to summarize information scattered throughout earlier parts of this report; (b) with respect to cash flow statements to introduce new material. [Also included in 5(b) and 5(c)] **[AIMR/FAPC92, p. 42]**

Comprehensive Income

The FASB's Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements," paragraph 70, defines comprehensive income as follows: **[AIMR/FAPC92, p. 42]**

> *Comprehensive income is the change in the equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.* **[AIMR/FAPC92, p. 42]**

We refer to comprehensive income several times above and have urged the FASB to construct the bridge from concept to standard. It is needed for better and more useful financial reporting in the following areas: **[AIMR/FAPC92, p. 42]**

1. Reporting the effect of changing market values and their effect on the wealth of the enterprise. One of the primary obstacles to acceptance of "mark-to-market" accounting is how it would magnify the volatility of reported earnings. If both unrealized and realized changes in market value could be revealed for what they are, separately from the results of operating activities, we as analysts would have more information than we do currently and we might avoid the stock market palpitations that frequently occur because of the information content of a single aggregated number called net income or earnings per share. **[AIMR/FAPC92, p. 42]**

2. Earlier we suggested that goodwill should be written off at the time it is acquired. We did not opine as to whether the write-off should appear on the income statement or go directly to owners' equity. If the concept of comprehensive income were developed, we would expect the goodwill write-off to appear as a component of income separate from the operating activities of the enterprise. **[AIMR/FAPC92, p. 42]**

3. In our discussion of the attest function, we advised an experiment with five-year intervals between audits, accompanied by a retrospective view of annual income for the five-year period that discloses all components of income making one year not comparable with the others. Before that experiment is launched, some attention must be paid to the concept of income used to guide the five-year retroactive view. **[AIMR/FAPC92, p. 42]**

There are other topics in which there is need for a developed concept of comprehensive income. The Financial Accounting Policy Committee of AIMR (and its predecessor organization, the Financial Analysts Federation) has consistently supported the an all-inclusive income statement format, known colloquially as the "clean surplus" approach. We consider income to include all of an enterprise's wealth changes except those engendered from transactions with its owners. We have profound misgivings about other wealth changes that elude disclosure on the income statement. Yet, individual items may be interpreted differently. That calls for a display of comprehensive income that allows components of different character to be seen and evaluated separately. Some examples follow. **[AIMR/FAPC92, p. 43]**

Unrealized Losses on a Long-Term Portfolio of Marketable Equity Securities FAS 12 requires the cumulative net unrealized loss on equity securities to be reported directly and separately in the owners' equity section of the balance sheet. That treatment has the effect of reporting the portfolio on the balance sheet at the lower of cost or market, but recognizing gain and loss on the income statement strictly on the cost basis of valuation. There seems to be no conceptual basis for such accounting, nor does it serve in any way the interests of financial statement users. However, we consider unrealized security gains and losses to differ in character from realized ones, and even more so from other corporate operating activities. They should be included in comprehensive income, but displayed in such a manner so that they may be evaluated on their own. This is an important matter to be considered by the FASB, the IASC, other standards-setting bodies, and the SEC as they propel corporate reporting nearer to mark-to-market accounting. **[AIMR/FAPC92, p. 43]**

Accumulated Net Gain or Loss from the Translation of Foreign Currencies FAS 52 changed the criteria and methodology for the translation of foreign currency and at the same time mandated that the "gain" or "loss" from using the current rate method of translation bypass the income statement until such time as the foreign operation was wholly or partially disposed of. We must observe that these are not true "gains" and "losses." They merely are the amount(s) by which the balance sheet is thrown out of balance because the assets and liabilities of a foreign operation are translated at the current rate, but the owners' equity accounts are not. Although it is difficult to visualize those gains and losses as legitimate components of income, under the translation methodology specified by FAS 52 we have no other choice.[13] **[AIMR/FAPC92, p. 43]**

Unusual and Nonrecurring Items, Restructuring Charges and Similar Items This classification could be broadened well beyond the current category of extraordinary items. It also should be presented in some detail. Some of the items in this group are now presented as extraordinary and shown net of tax. Others are set out as separate line items in income from continuing operations. Still others, such as the effect of lifo liquidations, are ascertainable only by scrutinizing the footnotes. Individual companies tend to have idiosyncratic definitions of what is unusual or nonrecurring, as well as eccentric thresholds of materiality. Analysts often are confounded by all of this as they attempt to make comparisons between and among companies, particularly over a time span of several years. **[AIMR/FAPC92, p. 43-44]**

The above lists are not exhaustive, but they should be sufficient to support our case. We have not suggested the form or content one or more standards on this subject should take. That is a task for the standards-setters themselves. Our more modest objective merely is to establish the compelling need for attention to this topic. Financial statement users need in one place all the data reporting economic activity which they then may sort out to suit their own purposes. The resulting income statement format needs codification of its structure to assure that like items are classified similarly by different companies. Only then will analysts be able with increased confidence to make many of the comparisons so vital to their work. **[AIMR/FAPC92, p. 44]**

[Context] The AIMR report's introduction to the section entitled "Summary of Important Positions and Guide to Future Actions" begins and ends as follows:

Much of this report relates to the present state of the art and implications for future developments in financial reporting. Righfully, so do most of the positions stated in this section . . . [T]hey all build on positions taken by AIMR in the past . . . [Also included in 1(b), 1(d), 3(d), 4, 8(c), 11(a), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 59]**

We expect the positions set forth below to build on the precedents of the past. That does not prevent them from breaking new ground, but they do not introduce significant inconsistencies with previous AIMR positions. To the extent that they do establish new stances those are

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[13] We note here the lack of conceptual basis for the current rate method. Furthermore, it does not provide information useful in analysis because of its untoward characteristic of producing accounting numbers that resist interpretation. Although we did not strongly oppose the issuance of *FAS 52*, we wish to make our current feelings known. Nevertheless, important as that matter is, it is extraneous to the point we are making here about comprehensive income.

largely the result of the changing world that we describe earlier in this report. [Also included in 1(b), 1(d), 3(d), 4, 8(c), 11(a), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 60]**

Those two paragraphs introduce the following summary of a position taken by the Committee.

Develop Standards for Reporting Comprehensive Income
Financial analysts continue to place heavy emphasis in their work on the income statement. It produces the numerator of earnings per share calculations and the denominator of the price to earnings ratio, two stalwart numbers in the investment world. Analysts also recognize that earnings comprises a multitude of components of varying quality: some are repetitive, others are not; some are operating items, others are not; some are the product of accounting rituals, others are not; some represent economic events of the current period, others do not. Much effort is required of analysts to locate and evaluate all of the income statement items that can have a bearing on their forecasts of the future and the valuation of the firm. [Also included in 1(d)] **[AIMR/FAPC92, p. 63]**

Much of this report is devoted to marshalling evidence and arguments to support our position that the FASB needs to move comprehensive income from concept to application. We believe the arguments are strong and hope to see progress in this matter in the not-too-distant future. [Also included in 1(d)] **[AIMR/FAPC92, p. 63]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the types of information they use to achieve their objectives, investors were asked about the notion of "core earnings." One investor also made a comment on the display of the income statement.

Committee/Staff/Observer
Also, another thing we keep hearing is that analysts really want to get at "core earnings"; if everything was the same on an ongoing basis, eliminating the nonrecurring items, what would be the earnings? So, perhaps we should recommend that the income statement show "core earnings" and "comprehensive earnings"? **[TI 10/16, p. 38-39]**

Participant I-2
I used a similar concept, "normalized earnings" on a quarterly basis. For example, for [name deleted], I take out the $280 million pension credit, I take out foreign exchange gains and losses, and I normalize the tax rate. You have to be careful not to confuse people too much because you can normalize things so much that they won't have any idea of what you are talking about. But you have to normalize on a quarterly basis. Other adjustments are gains and losses on asset sales and insurance settlements, etc. [Also included in 1(b) and 11(a)] **[TI 10/16, p. 39]**

Participant I-6
I try to come down to what are the earnings from the current businesses that are there today, and are they going to be the same ones next year? So, if they have written off a complete line

of business, I back it out and get rid of it. What I have seen from a couple of companies I follow, and what I would like to see, is two EPS numbers; one is the traditional GAAP reporting number, and one based on the earnings excluding the nonrecurring items and comparing them to the prior period excluding the same things so that we have some comparability. But that is just starting to come out. [Also included in 1(b) and 2(c)] **[TI 10/16, p. 41]**

Participant I-9
One thing for the committee to consider on the previous question. Look at the "other income" line of the company going forward. You're going to have joint ventures and a more complex world. The "other income" line was set up to net interest income and interest expense and when you put [names deleted] and all these deals in there, this line can go from $10 to $200 million in 3 years and it's not adequately reported now. [Also included in 1(b) and 6] **[TI 10/16, p. 51]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of unconsolidated entities. During the discussion, comments were made on income statement display.

Participant I-7
At a very minimum, there should be a clear distinct separate line item called equity income. Most of my companies fold the equity income in the "other income" account. [Also included in 6] **[TI 12/9, p. 34]**

Participant I-12
In some companies, I've found that the other income line is the second largest revenue line, and in some the largest, and it's shown at the very bottom. So we know there's something in there of some order of magnitude, but the company is not breaking that out. The same goes for the "other expense" line. [Also included in 6] **[TI 12/9, p. 34]**

Participant I-6
Yes, but again subject to materiality. Something that would also be helpful would be a list of everything that's in the equity line. It doesn't have to be in the annual report; maybe it could be an exhibit that you could call and ask for if you really care about it. The key point is that the make-up of that line item changes over time dramatically and if you're looking at 5 year disclosure, it's not unimaginable that 80% of the make-up has changed in that 5 year period. [Also included in 6] **[TI 12/9, p. 37]**

Participant I-7
The information that we're looking for could be issued as part of the 10-K rather than the annual report because companies are increasingly complaining about the cost of their annual report. [Also included in 6] **[TI 12/9, p. 37]**

Participant I-6
It could be in the 10-K or in the exhibit to the annual report, but I think that we need more than just that one line item in the annual report. [Also included in 6] **[TI 12/9, p. 38]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
The next three questions refer to an area that accountants refer to as display. By that we mean the classification, layout, and level of detail of information on the face of the financial statements or the related notes that provide additional information about the details of amounts recognized in the financial statements. Is everybody comfortable by what we mean by display? **[TI 1/13, p. 26]**

Accounting standards do not provide much guidance about display of information in external reporting. Most of the guidance we have is 20-25 years old. Thus, there may be considerable opportunity to help you with your work through better display of information. We suspect that better display could improve your ability to predict a company's future for at least three reasons: (1) first, more details or a better classification could provide more insight about a company's business than you currently get, (2) second, rearranged classification of information between recurring and nonrecurring items could help you identify core or basic or recurring earnings, (3) and third, more explicit guidance about display could reduce diversity in reporting by companies in similar circumstances and improve comparability of information. We think that the seldom-heard-about topic of display offers fertile ground for improvement and we look forward to your ideas and views. **[TI 1/13, p. 26]**

First, let's talk about the income statement, more specifically about the reporting of nonrecurring items in the income statement. Should financial reporting do a better job of identifying nonrecurring items? If so, what definition of nonrecurring items would you find most helpful in your work? **[TI 1/13, p. 27]**

Participant I-11
I hope you recognize this is about as much of a pandora's box as fair value! I would like to see identified, either on the face of the financial statements or notationally, those income statement items which are not related to the normal course of business for the company. If you ask me what that means, I say it's subject to interpretation. I can remember a number of years ago when a number of companies reported extraordinary items virtually every quarter because that way they could keep the preextraordinary earnings' track heading up. It's a continuum but clearly there are items that are not directly related to the normal course of business of the company and clearly it would be helpful to me as an analyst to have those items segregated and identified so that I can assess them and adjust for them. **[TI 1/13, p. 27]**

Participant I-8
You're getting all that you want now only when it's a negative. I would love to see some management say something on the positive side. You get pretty much all the negative stuff. I

can't imagine a management not wanting to disclose something that is extraordinary and that is negative. **[TI 1/13, p. 27]**

Committee/Staff/Observer
Restructuring charges, for example, are required by the SEC to be shown above the line, before you get to operating earnings. Is that a problem? [Also included in 1(c)] **[TI 1/13, p. 27]**

Participant I-8
No, because it's disclosed. I can make whatever adjustment I want to it. [Also included in 1(c)] **[TI 1/13, p. 27]**

Committee/Staff/Observer
But you would make an adjustment to get to core earnings? [Also included in 1(c)] **[TI 1/13, p. 27]**

Participant I-8
Well, there are extraordinary charges and extraordinary charges. There are some that are really a result of some change somewhere and there are others that just reflect poor management judgment over some period of time. My guess is that management is less inclined to disclose positive items than negative items because the latter explain why they did so poorly. [Also included in 1(c)] **[TI 1/13, p. 28]**

Participant I-7
You're a $15-$20 million company and in the normal course of business, you get the Walmart account just to fill the pipeline; there's $10 million worth of business. It's going to show up in the normal course of business, but I would like to have some notational evidence that you got that piece of business. **[TI 1/13, p. 28]**

Participant I-8
We talked the last time about purchase accounting and that's the one area where I think there is not sufficient disclosure. For example, write-downs of inventories purchased and then subsequent gains on the sale of those inventories; this is a one-time deal that is not properly disclosed. It doesn't reflect what is going to be the ongoing profitability of that manufacturing operation. [Also included in 8(b)] **[TI 1/13, p. 28]**

Participant I-15
Lots of companies define differently what is nonrecurring and what is material, even from quarter to quarter. It's not consistent. **[TI 1/13, p. 28]**

Committee/Staff/Observer
Even though there might be a "big bath" writeoff, isn't the bottom line number before that writeoff the more meaningful number going forward? **[TI 1/13, p. 28]**

Participant I-8
I agree with that. But [committee/staff/observer] was asking whether it matters if it's above or below the line, and the answer is no. **[TI 1/13, p. 28]**

Participant I-7
I just don't think we're getting enough information, especially when major restructuring charges are made. **[TI 1/13, p. 29]**

Committee/Staff/Observer
Next question. If financial reporting should better identify nonrecurring items, what information should be reported? **[TI 1/13, p. 29]**

Participant I-7
At a minimum, if you take a $5 billion writeoff, I would like notationally some idea about how the $5 billion is split between inventory, physical assets, and what's to be paid out to the employees, and anything else. **[TI 1/13, p. 29]**

Participant I-8
The distinction between cash and noncash is more important to me; how much is going to be noncash. You always have to ask that; I think it should be part of the disclosures. **[TI 1/13, p. 29]**

Participant I-7
To the extent you get a split between the different assets, you should be able to get some idea. For example, if out of the $5 billion, $4.5 billion is employee related, that's cash. **[TI 1/13, p. 29]**

Participant I-8
Of the noncash portion of it, I'm not sure I learn anything from whether they wrote down plant or inventory. **[TI 1/13, p. 29]**

Committee/Staff/Observer
Would it be a useful exercise to attempt to define core earnings? If so, would it be helpful to you if a company presented an income statement to arrive at core earnings? **[TI 1/13, p. 29]**

Participant I-8
How would you say that's different from what the company is reporting as earnings before extraordinary items? **[TI 1/13, p. 30]**

Committee/Staff/Observer
For example, securities gains for manufacturing companies. **[TI 1/13, p. 30]**

Participant I-8
I said that before. We have a harder time seeing when they have unusual pluses; they're very happy to show you unusual minuses. **[TI 1/13, p. 30]**

Committee/Staff/Observer
So it would be useful if there was a common definition of core earnings? **[TI 1/13, p. 30]**

Participant I-11
I get a little confused on the differing definitions of unusual items, nonrecurring items, extraordinary items. In addition to the cash and noncash aspects, I would like to see the tax consequences of these events. Sometimes I get reports that just have the net after tax effect, sometimes only pretax effect, sometimes both. Trying to translate back and forth between operating income and net income is impossible. I think we would find that core earnings is a difficult thing to define precisely, although we all have an intuitive sense of what it is. **[TI 1/13, p. 30-31]**

Committee/Staff/Observer
There are rules that specify that management cannot say "we consider this to be an unusual item; although it is part of our business, we don't believe it will happen again". Companies are prohibited to show that as a separate line item as an excuse. It's not a restructuring, it's not a "big bath", it's something that happened and is incidental to the company's business, but it is unusual. **[TI 1/13, p. 31]**

Participant I-10
But can't you allude to that fact in the notes to the financial statements? **[TI 1/13, p. 31]**

Committee/Staff/Observer
Yes, in notes you can. If we focus on core earnings as being the best evidence of what happened during the period, that is likely to be the best evidence of what's going to happen in the next period. We would get a considerably different answer than we get today for operating income. **[TI 1/13, p. 31]**

Participant I-12
Every analyst I know has a different definition of core earnings. I'm not sure there is a proper definition. For example, bond trading for a securities firm; is that recurring? If the bond trader doesn't come in, you're not going to have bond trading gains or losses. There are certain volatile elements that have a lot of discretionary aspects to them, and I'm not sure how you would break those out or create an accounting rule to cover those instances. **[TI 1/13, p. 31]**

Committee/Staff/Observer
What if the accounting rule or the definition attempted to equate items that you apply a multiple to versus those that you treat one to one? The former would be included in core earnings, the latter would not be. **[TI 1/13, p. 32]**

Participant I-11
But those items are not going to be the same this week and the next. **[TI 1/13, p. 32]**

Participant I-5
It's true that we won't all agree on what that exact right number is for core earnings, but what's wrong with having some rough consensus around which we adjust, rather than having only net income? For presentation purposes, I don't see why it wouldn't add more relevance. **[TI 1/13, p. 32]**

Committee/Staff/Observer
We will now consider opportunities for display of information that would give you better insight into the operations of the company's business. In previous meetings, each of you have stressed the importance of understanding as much as possible the operations of the company's business. As discussed in the meeting materials (pages 16 and 17) the form of display used today provides some information about the company's business. Nevertheless, there may be opportunities to improve the display in a manner that gives you more insight into companies' operations. Our questions are: would more information about the detail of certain amounts currently reported in the income statement be useful? If so, which amounts and what information would you like to know? Alternatively, would a different method of classifying information on the income statement give you more insight about the company's business than the current method of classification? **[TI 1/13, p. 32]**

Participant I-12
The display required for the companies I follow (banks and securities brokers) were determined 50 or 60 years ago. That display has little or no relationship to the way these businesses are run today. First of all, the average balance sheets in most intermediation companies is an absolute essential. In fact, if it were the only thing that I got, with notes on revenues and expenses, I would probably be very happy. With the income statement, I reclassify everything. I have a net interest classification, a fee and commission classification, a trading gain classification, a capital gain classification, and the ubiquitous "all other". So I restructure the income statement on an ongoing basis for the companies I do a model for. [Also included in 1(c)] **[TI 1/13, p. 32-33]**

Participant I-8
I'd certainly welcome having operating expenses broken down into the 3 categories of fixed, semi-variable, and variable for manufacturing companies. If you'd give me the cost accounting, I'm not sure I'd know what to do with it. **[TI 1/13, p. 33]**

Participant I-14
I had that one marked also. **[TI 1/13, p. 33]**

Participant I-11
I'm not so sure about the semi-fixed and variable, but personally I'd like to see selling expenses separated from general and àdministrative expenses, because selling expense are more closely related to sale volume and has different dynamics from G&A. **[TI 1/13, p. 33]**

Participant I-8
That's not entirely true. In a lot of companies that I deal with, the salesmen get paid a fixed salary and there's also a variable part in the compensation. I have encountered very few cases where selling expenses are all variable. **[TI 1/13, p. 33]**

Participant I-11
I deal a lot with distribution companies and I have some formulas that I use and that seem to work pretty well, where I drive my projection of selling expenses based on sales, and I drive my projection of G&A based on some other factors and, occasionally, my forecasts are right. I would like to see notational information about where the depreciation comes from; how

much goes into costs of goods, how much goes into S,G&A. [Also included in 1(c)] **[TI 1/13, p. 33]**

Participant I-7
I don't know if there necessarily has to be a dramatic change in the display of the P&L. For example, [name deleted] notationally breaks out the costs of goods sold and the S,G&A. If you're doing some ratio studies, there are some companies that will give you a separate line item for R&D; other companies will include R&D in the S,G&A account; still others will include it in the costs of goods sold account. I would like to use as a guideline the cost breakouts that a company like [name deleted] gives in their annual report, including things such as social security taxes, advertising expenditures, etc. **[TI 1/13, p. 34]**

Participant I-12
In this day and age, it's important to be able to identify the people costs from the nonpeople costs in the income statement. The one good thing about the disclosures of financial companies is that they show personnel expense (basic salaries plus fringe benefits) and that's very useful. **[TI 1/13, p. 34]**

Committee/Staff/Observer
Are those consistently defined, [participant I-12]? **[TI 1/13, p. 34]**

Participant I-12
I don't know. It's about as consistent as you can get considering the variability across the spectrum of financial companies that I cover. I feel fairly confident that I can rely on those numbers. **[TI 1/13, p. 34]**

Participant I-7
The only consistency there is in my industry is the fact that only one company discloses that information. **[TI 1/13, p. 34]**

Participant I-12
Another point is that companies that run similar businesses report in vastly different fashions. The income statement of [name deleted] is vastly different from the income statements of other kinds of financial companies; yet, their basic business is very similar. So there is an issue of noncomparability for comparable businesses, both in the income statement and the balance sheet. [Also included in 2(c)] **[TI 1/13, p. 34]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display. At the end of the discussion, participants were asked whether they had any enthusiasm for display issues.

Participant I-8
I have great enthusiasm for [the presentation of] fixed, semi-fixed, and variable [expenses], just as much as for segment reporting. [Also included in 3(e)] **[TI 1/13, p. 41]**

Participant I-7
I would like more consistency on the display of depreciation and R&D expenditure. On R&D, I'd like to know whether it falls under a separate category or in the S,G&A. In depreciation, where I get one number, I'd like to know how that is split up between the two major cost accounts (S,G&A and costs of goods sold). **[TI 1/13, p.42]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of disclosure about operating opportunities and risks. During the discussion, an investor answered a question on core earnings.

Committee/Staff/Observer
Do you adjust core earnings for items that you think are hedges but are not accounted for as hedges, or vice versa? Or do you generally go along with the accounting for these instruments? [Also included in 19] **[TI 1/13, p. 51]**

Participant I-7
To the extent that some of my companies operating in the international markets try to currency hedge, I won't change the accounting unless it's significantly material (for me, above 5%). I won't make a change in my written material. [Also included in 19] **[TI 1/13, p. 52]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality. During the discussion, comments were made on core earnings.

Committee/Staff/Observer
We've talked about the quality of earnings; how would you define quality earnings? We've talked about the concept of core earnings, which I would define as the earnings to which a multiple greater than one is applied. Can any analogy be drawn between core earnings and quality earnings? Could I think about quality earnings in terms of a multiple? Are good quality earnings that you apply a multiple greater than one to, lower quality earnings something you apply a multiple of one to? [Also included in 2(b)] **[TI 3/17, p. 34]**

Participant I-16
There are two ways of looking at it. One is the conservatism aspect; for example, companies using accelerated depreciation using the same useful lives as another company using straight-line, are clearly more conservative and are perceived as having better quality of earnings. The second aspect is predictability and stability. If you believe a company can report earnings of at least that much in the next year, it's worth more than if you have no idea. For example, if I had the earnings of [name deleted] for one year and ask how much it's worth, I wouldn't have any idea because I don't know whether they made any money in the prior year and whether they would make any money in subsequent years. [Also included in 2(b)] **[TI 3/17, p. 34-35]**

Participant I-7
One of the problems I have in answering that question is that earnings quality is only one aspect entering into the valuation of a company. For me, earnings quality is only one measurement of valuation. [Also included in 2(b)] **[TI 3/17, p. 35]**

Participant I-12
I would focus on the concept of earnings quality equals predictability. For example, [name deleted] is considered among the highest quality in the brokerage business, a highly volatile business. The company typically gets a substantial discount to the S&P multiple because they have a merchant banking operation where they periodically take gains. You take those numbers out and then look at the P/E and it gives you an entirely different perspective, because the market is looking at the predictable elements. I think of core earnings as operating earnings; the merchant banking part is not an operating business. What I assign a multiple to is the portion of the earnings where I have some ability to predict them. [Also included in 2(b)] **[TI 3/17, p. 35]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on core earnings and income statement display.

Committee/Staff/Observer
Question 3. To what extent, if any, do you consider the entrenched intrinsic value of a company as you think about credit? We have a mirror group of folks that are equity side people who meet like this, and clearly intrinsic value of company is a very big discussion with them, including things like normalized core earnings. So what we're trying to find out is whether or not their concerns and your concerns run parallel, or on different paths, and if so, how. [Also included in 1(a)] **[TC 12/8, p. 13]**

Participant C-1
We use multiples of cash flow. So we're using earnings before taxes, depreciation, amortization, and multiples of that. The problem with determining normalized or core earnings is the amount of so-called one time charges which are always run through a company's income statement. The amount of time spent looking at pro forma cash flows or pro forma earnings is tremendous. The number of companies selling divisions, selling plants, closing plants, or looking at buying companies and then merging them makes it very difficult for us to look at normalized cash flow and determining intrinsic value of that. [Also included in 1(a) and 1(c)] **[TC 12/8, p. 13]**

Participant C-13
Second, an entirely unrelated observation would be that in the area of company data, I think it would be very helpful to us to get a sense of the distinction between fixed and variable costs. [Also included in 1(b)]**[TC 12/8, p. 25]**

Participant C-1
That's very difficult, because I think that core earnings is equally critical. The problem with core earnings is just that the accounting standards have become so much more complicated that they tend to even hide further what core earnings are. [Also included in 15] **[TC 12/8, p. 26]**

Participant C-4
I deal with a lot of smaller companies that probably a lot of you, revenues of $50 million and less primarily. Understanding core earnings is a key to our analysis, and I see no consistency in footnotes of supplemental information that we're receiving for customers of that size. One good example of what we need would be a cost of sales breakdown. That helps us assess cash flow, assess profitability, gross profits, and what's causing the gross profits to fluctuate, what's causing the cash flow to fluctuate. Overhead schedules are very important, and in percentage of completion accounting, open and closed job schedules are essential in determining the success and the prospects of the company that we're trying to grant credit to. [Also included in 5(b) and 15] **[TC 12/8, p. 27-28]**

Participant C-12
I deal mostly with large investment grade institutions, and I find in general they do a pretty good job of giving me information I need to see to know what the core earnings are. For example, [name deleted] in its quarterly press release will give me a chart showing the changes quarter to quarter in ten different items, but they've never told me what they earn in credit card. One of the most basic segments I'd want to get just is not there. So, segment information is my first priority. [Also included in 3(a), 3(b), and 15] **[TC 12/8, p. 28]**

Participant C-5
Core earnings are the key for us. Comparability of revenues and expenses from prior periods, same store sales, subscriber counts, whatever it is. And then capital expenditures is an item that is just under-addressed. And all of that allows me to understand the contribution to future earnings or future reduction in cost, likely expenditures moving forward, the quality of return on recent investment in plant and equipment. It all gets back to core earnings. [Also included in 15] **[TC 12/8, p. 28]**

Participant C-3
When you look at a large financial institution, the biggest question that pops up is whether the accounting model that we're using is right. That focuses on the mark-to-market issue. The investment portfolio discussions that have gone on is really just the tip of the iceberg. In looking at some of the companies that I look at, segments become the secondary issue; how you determine earnings is the number one issue, or what are the earnings of a company. [Also included in 4 and 15] **[TC 12/8, p. 28-29]**

Participant C-5
Management salaries are important in the small company environment. And those typically we don't get broken out. We also deconsolidate finance companies from the consolidated financial statements of commercial companies. [Also included in 1(b)] **[TC 12/8, p. 46]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on income statement display.

Committee/Staff/Observer
At the bottom of page 4 of the meeting materials, there's a position put on the table that I haven't heard talked about yet. It says that if you used fair value, rather than historical cost, as the measurement basis of financial statements, you might get different measurements of income that might make cuts you don't currently see. The typical example is that inflation will allow companies to look like they're growing because historical cost makes no discrimination about the size of the dollar that's in the balance sheet or the income statement. Where dollar or standard dollar value financial statements or current cost statements or any other varieties that have been proposed over the years would separate out holding (inflation) gains from real gains. So, for example, ABC Company sells 100 widgets every year. And the 5% inflation every year makes it look like the sale of those same 100 widgets is revenue growth. And ABC Company has about the same profit every year. So, from the point of view of what's really happening, ABC Company is really losing against inflation, and perhaps even doing some self liquidating. Is that issue important to you to get an alternative measurement of earnings that somehow makes that cut? And if so, how do we do it, if at all? [Also included in 4] **[TC 2/2, p. 9]**

Participant C-13
In the example you cite, the very first question you ask management about revenues is what's the price impact; that's the simple answer to that question. [Also included in 4] **[TC 2/2, p. 9]**

Committee/Staff/Observer
And you're telling me that is part of what you do? [Also included in 4] **[TC 2/2, p. 9]**

Participant C-13
Yes. You're identifying the price impact on revenues directly for that particular enterprise as opposed to being on a generalized basis. So you're getting to the heart of the problem as it relates to that specific enterprise rise relative to inflation. [Also included in 4] **[TC 2/2, p. 10]**

Committee/Staff/Observer
If you start at the top, then, and you say, okay, I now am going to identify the price per unit effects here, do you do any analysis down from there? And, if so, what? [Also included in 4] **[TC 2/2, p. 10]**

Participant C-13
Let's take a soft drink company such as [name deleted]. The domestic unit growth is low. But the overseas unit growth continues to be very satisfactory. So, you disaggregate. Then you need to disaggregate the price impacts, domestically and also in major overseas markets.

So the next stage is disaggregation of aggregate information. [Also included in 4] **[TC 2/2, p. 10]**

Participant C-4
In construction, all of the contractors typically lock at prices at the beginning of a contract so the gains that occur are on completion of projects. So this information to us is not that crucial. [Also included in 4] **[TC 2/2, p. 10]**

Participant C-2
I think we are accustomed to dealing with these issues of how comfortable we can get with this notion of inflation gains through the analytical process. I think we address the issues. We don't necessarily need to have them screened out for us. [Also included in 4] **[TC 2/2, p. 10]**

Participant C-4
You do run the risk of information overload here, too, at times. You've got to remember that the typical analyst has to get into separating those two elements out. We have some significant borrowers who have been pretty effective in locking in costs by hedging commodity prices or whatever. And that's part of what we would consider operating management. Is that truly manufacturing efficiency that allows you to take that commodity and turn it into a product at a low cost? Or is it your effectiveness of your hedging strategy such that you lock in early commodity prices? We look at it as one big operating process and the quality of management is all a part of that activity. We're pretty good at analyzing numbers but I could get into information overload if you gave me too much. [Also included in 4 and 19] **[TC 2/2, p. 10-11]**

Participant C-2
The point is the cost of determining that in light of that information. And I think for many credit granters we're working with financial statements of small businesses. I think if cost to develop that information becomes more onerous than it presently is, we're going to drive those businesses away from audited financial statements to our detriment. [Also included in 4 and 17(a)] **[TC 2/2, p. 11]**

Participant C-17
As lenders, you tend to know customers. So as these issues come up, because of increasing inflation, half the time they're telling you about it or you're asking about it, and whatever. So I think sometimes you can get to the point where it becomes overload. [Also included in 4] **[TC 2/2, p. 11]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
Assurance is an issue that we'll talk about at the next meeting. I'd like to move to page 7 of the meeting materials, Roman numeral II, to issues called display. Display is a notion of what information shows up on the face of a financial statements or in a footnote explaining the

financial statements. It is different than measurement, where we're arguing about whether historical cost or some other values should be used. It has to do more with telling you how much information is needed to know about things. This discussion is broken up, beginning on page 8, among income statement, balance sheet, and cash flows and I think we have the final one that has to do with some risk and uncertainties, as well. From an accounting point of view, a non-recurring item is an item that's not supposed to happen again. As opposed to an unusual item, which is an item that probably is not an everyday occurrence, but the fundamental distinction is it is not part of our ordinary business. The questions of both 5a and b in the meeting materials are: are you satisfied with the amount of identification currently in financial reporting of non-recurring or unusual items? If not, where would you draw the line? Would you let management make its own decisions about what it would label as those? If not, who would make those decisions or should we have some objective criteria that we hold up and measure all these things against? **[TC 2/2, p. 12]**

Participant C-11
This is a very difficult area. Extraordinary, if we're talking about really non-recurring things like the adoption of 106 or something like that, that can be clear cut. I have been having a lot of problems, and I think every analyst must have had the same thing in every quarter now lately about people calling things non-recurring when they're actually happening rather often. And I'm thinking of the obvious restructuring activities that occur on an acquisition or the frequent dispositions we're now seeing. Or not dispositions necessarily, but, cost taken to restructure or to downsize a part of a company. I think that non-recurring is too absolute a word. But I do think we need differentiation between things that I just named that are certainly individually relatively unique events that occur and what I would call unusual items. But the bottom line really to me is that they get identified. I'm talking about the income statement here. I'm saying that as opposed to having it in the management discussion, particularly for the restructuring type things, because that's a two-year kind of picture that you're getting in the management discussion, and it can be just lost in the morass from one annual report to another. The most important thing is that they be identified so that an analyst, if he or she wants to ask more questions, at least is given a clue that something different happened here. I don't think that the magic answer is the difference between unusual and non-recurring. Non-recurring is an absolute word the way it's been used in recent years because there just are lots of restructures going on that aren't going to be non-recurring. [Also included in 13] **[TC 2/2, p. 13]**

Participant C-5
In day-to-day financial analysis, I've sort of given up distinguishing between non-recurring and unusual because of the types of items that have slipped in those categories. We are back to making our own determinations of what we consider to be non-recurring and not everybody does your own analysis. As a lender, you have the unfair advantage of getting additional supplemental financial information so that you explore into those items, to figure out what they are. You make your own determination. One of the big items that's not in there is the cash and non-cash nature of those items. These large reserves that are set up in these restructuring charges: how much of this is actually cash and how much of it is not? So we've got to get back to cash impacts in many cases. So I would just say that what I thought was a real restrictive guidance to get most things back into the operating statements, as true operations, and realizing that even disposing of businesses, cutting staff and laying off employees, were

classified as operating activity, disturbs me and I've sort of given up on the way they've been presented except for our own analysis accounts. **[TC 2/2, p. 13-14]**

Participant C-13
The key is establishing what the core earning power is. I don't have any difficulty with your definition of non-recurring as something that never happens again. Although like in [name deleted], there were five straight years of non-recurring charges! But where I have a little difficulty is the definition that you made of unusual. An unusual item, it seems to me, can be something that does occur in the normal course of operations, but doesn't occur that frequently. Therefore, its occurrence is distorting the results. I guess a 100 year hurricane for a casualty insurance company would be one example. And I think under your definition, it wouldn't be necessary to disclose the separate impact of that on operations. Clearly, it's something that one would need to know. **[TC 2/2, p. 14]**

Participant C-2
I would basically concur with that. To me, it doesn't matter much if you call it non-recurring or unusual. I'd like to be able to quantify that out, look at it separately, understand the underlying transactions reflected in whatever those numbers may be. Make some judgments about whether or not they really would be part of earnings or not. What the impact on cash flow either has been or will be. And so to have them highlighted in some way would be very useful. **[TC 2/2, p. 14]**

Participant C-4
Our focus is on earnings as we said in our last session. Discretionary expenses--profit-sharing contributions, bonuses, may be very usual and recurring, but, nevertheless, not a true indicator of the operations. **[TC 2/2, p. 14]**

Participant C-14
I was just going reemphasize the importance, for a second, of cash and non-cash impacts. Just because companies have put things that may be not recurring does not mean that it will signify something very important. On the other hand, there's the quality of historical earnings. **[TC 2/2, p. 14]**

Committee/Staff/Observer
How would you feel about letting management pick and choose what is unusual or non-recurring? **[TC 2/2, p. 14]**

Participant C-13
I understand that problem, but to a certain extent, you're going to have to rely on management. There, too, you're raising a problem. But you've got the oversight of the auditors and the SEC, between that and your own investigation and knowing what the nature of the business is, you should be able to establish what these items are. [Also included in 17(a)] **[TC 2/2, p. 15]**

Participant C-5
On the expense side, you always assume that management would like to clean as much out of operating items as possible, so there you can take the broadest definition and converse on the

income side. I'm not uncomfortable with management taking the lead on that decision with some accounting supervision. On the expense side, if they choose to treat them as operating expense, I've got to assume that they're leading us to believe that don't expect this to be a one-time event regardless of what the definitions are. That we are going to continue to downsize at [one company] over the course of quite a few years here or [another company] and the like. I think the accounting standard has forced them to try to get as much down there as possible instead of really trying to be honest with their constituents, the investors, the creditors, and so forth, about whether they believe they're non-recurring. **[TC 2/2, p. 15]**

Participant C-15
I believe a lot of management incentive compensation programs are tied to the operating earnings. I think I would prefer someone with a little bit more objectivity and less direct interest in the outcome make those judgments rather than having management make those types of judgments. **[TC 2/2, p. 15]**

Participant C-17
When I go through an income statement, what I'm trying to figure out is what are sustainable earnings? What's going to come in every year and what's ordinary to the operation? What are controllable expenses? What are discretionary expenses? And what's cash versus non-cash? And regardless of how you categorize it, all that gets back to what is the predictable level of cash flow that this company's going to be able to generate. **[TC 2/2, p. 15]**

Committee/Staff/Observer
Let me focus with you on page 9, item C [of the meeting materials]. Our question is whether or not more detail is what you wish, what users need. As users, would you say you need more detail in the income statements? Is that part of the solution? **[TC 2/2, p. 16]**

Participant C-11
I think that we're in a complex world and if there are "unusual or non-recurring" things going on, that's the reality. And if you force the accounting statement to do something else, to say something else, make it simple, indeed, for a database, you're making just a horrendous mistake. I think I can make an absolute statement along those lines. [Also included in 16(a)] **[TC 2/2, p. 16]**

Committee/Staff/Observer
Are we clear about what we're talking about, about a database? I think we need to be careful. We're talking about raw information about a company, not about a database of a lot of companies, all putting the same information in so that you can compare. We're talking about a company, in essence, opening up its books and saying, here, take whatever you want. That's what you were talking about, right? [Also included in 16(a)] **[TC 2/2, p. 16]**

Participant C-2
Kind of like on an on-line real time basis. [Also included in 16(a)] **[TC 2/2, p. 16]**

Participant C-11
As opposed to the EDGAR type. What we're talking about here is when an individual company has something occurring that either makes the reported earnings significantly

different or if some restructuring or whatever is going on, that gives you specific information about something that's happened, that is not in the ordinary category of revenues and expenses. So I would answer in that context. If you talk about opening the books, that obviously doesn't work, you have to have some control and framework for the numbers that you're reporting. [Also included in 16(a)] **[TC 2/2, p. 16]**

Committee/Staff/Observer
Most accountants do not like standards or rules that are based upon a mathematical test. But if there were a mathematical test, for example, any transaction that is a disposal of an asset, or the settlement of a liability, which is not an ordinary course of business transaction, and that produced a result, gain or loss, above 5%. Would some notion of that kind of a disclosure or presentation be useful? **[TC 2/2, p. 17]**

Participant C-13
My answer to that question is yes. I think that there are two issues here. One is the one that [committee/staff/observer] brings up which is the issue of materiality. The other is the issue of what kinds of information you want to display. I believe that the 5% materiality test is not nearly severe enough. And the materiality test should relate to the year-to-year changes in a company. In other words, if the item that you're describing -- be it a disposal of assets, or settlement from liability -- affects a change in year-to-year income of 5%. **[TC 2/2, p. 17]**

Committee/Staff/Observer
But there is a trap there . . . and that is that if you had a break-even year-to-year, that would suggest every transaction would hit the materiality test. **[TC 2/2, p. 17]**

Participant C-13
I know. I realize that. But, on the other hand, you can do an either/or. But the point that I'm making is that the changes in earning power, cash flow, from year to year are very important. Also from period to period. **[TC 2/2, p. 17]**

Participant C-4
A lot of times it may be difficult to release records of the company so if the accountants could standardize that information it would be helpful. Also, going back just for a second to the prior question about what additional information for the income statement. If some of the supplementary information that the accountants provide could be standardized, it would help in analyzing cash flows and doing some standard tests of balance sheet items. That type of information, if it's standardized, makes it a lot easier for an analyst to discuss with management and, looking at their internal records, to make comparisons based on year-end audits between companies. [Also included in 5(b)] **[TC 2/2, p. 18]**

Participant C-11
I have a subsidiary point to make on the indirect method. Often times, the item lumped together is depreciation and amortization. I think that there's a real absence often of good data, both in terms of what the amortization is, as opposed to depreciation of equipment. And also in a footnote context the time period for the amortization. Everyone knows that there are

now new capital ratios that give different weighting allowances for goodwill of different types. And it's astonishing to me that still very well recognized companies do not disclose goodwill at all in the published financials. So I think a lot more weight has to be put on differentiating those items than has been the case. [Also included in 5(c) and 7(a)] **[TC 2/2, p. 26]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 4—Income statement display

a. Does the information in the current income statement, related notes and MD&A generally provide you with sufficient information about *nonrecurring and unusual* transactions and events?

3 _ Yes 11 _ No

Participant C-2: Depends on the quality of the statements and disclosures, but generally no.

b. If NO, please indicate your preference for each following proposal regarding *income statement* display of nonrecurring or unusual amounts, by marking:

H Offers *high potential* for helping you in your work
M Offers *moderate potential* for helping you in your work
L Offers *very low or no potential* for helping you in your work

(If you checked YES in 4a, skip to question 4c.)

H, M, or L

____H-5,M-4,L-2Display separately the effects of nonrecurring or unusual transactions or events *based on management and auditor judgments* about which transactions or events are nonrecurring or unusual.

____H-4,M-7,L-0Identify nonrecurring or unusual transactions or events to be separately reported based on *specified criteria*. (Those criteria could be based on, for example, (1) the type of transaction, (2) the frequency of the transaction, or (3) the size of effect.)

____H-8,M-3,L-0Provide *more detail* about the cash and noncash portions of restructuring charges.

____H-7,M-2,L-2Provide *more detail* of items in the other income and expense caption(s), and nonoperating captions, using a materiality threshold that is much lower than currently used in practice.

____H-2 Something else. Please describe.

Participant C-17: Statement footnote or management narratives to detail and explain sources and cause: Also would allow annual comparison to check if nonrecurring had a habit of re-occurring.

Participant C-13: -- Note amounts before and after tax.
-- No netting of material amounts.

Participant C-4: Include a section in the P&L entitled "Discretionary Expenses." Include bonuses, profit sharing contributions, etc.

Participant C-11: In the present framework, realized gains or losses should be separated from operating income.

c. Please help us understand the types of information that you would find useful about *unusual or nonrecurring* events regardless of how defined:

Enter
H, M, or L
as in question b

____H-11,M-3,L-0 A *brief description* of each nonrecurring or unusual transaction or event.

Participant C-2: Will alert analyst so more information can be obtained.

____H-9,M-4,L-1The *gross effects on revenues and expenses* of nonrecurring and unusual transactions when shown "net".

Participant C-11: This would depend on the type of transaction.

____H-4,M-7,L-3The *tax effects* of nonrecurring and unusual transactions or events.

____H-2,M-5,L-6The *effect only on net income* of nonrecurring and unusual transactions or events.

____ Something else. Please describe.

Participant C-14: Cash flow impact (after-tax).

d. Does the information in the income statement, related notes, and MD&A generally provide you with sufficient information about the *recurring* operations of the company's business?

4_ Yes 10_ No

Participant C-2: Could be improved.

Participant C-6: Want to stress importance of consistency in reporting which I feel is not always followed.

e. If NO in 4d, please indicate your preference for the following:

H, M, or L
as in question b

____H-8,M-2,L-0Divide operating expenses into fixed, semi-variable, and variable categories

Participant C-11: For many nonfinancial companies.

____H-7,M-1,L-2Divide operating expenses into required and discretionary categories

Participant C-5: And capital expenditures.

____H-8,M-2,L-0Display the types and amounts of costs included in certain major captions (for example, cost-of-sales broken down by purchased materials, salaries, fringe benefits, occupancy costs, property taxes, and other major components of costs).

____H-3,M-5,L-2Display selling expenses separately from general and administrative expenses.

Participant C-11: On occasion.

____H-8,M-1,L-1Display the portion of cost-of-sales and SG&A expenses that is depreciation.

____H-3,M-5,L-2Indicate separately the portion of costs and expenses that relate to employees versus those that do not.

____H-6,M-2,L-2Indicate separately amortization of goodwill and amortization of identified intangibles from depreciation of property and equipment.

____ Something else. Please describe.

Participant C-17: 1) Rental (operating expenses) for real property and personal property.
2) Provision for bad debts or loan loss expense.

Participant C-5: Capital expenditures by revenue creating expense saving maintenance.

Participant C-12: The best format is a table showing "miscellaneous" income and expense items, with MD&A, providing comment on any nonrecurring items (as well as occurring, some of which I may discount as well).

Participant C-11: It is probably unproductive to devise one format that fits everyone. Data should be displayed that best fits the business of the entity, and preparers should feel under pressure to provide a breakdown that shows the most important dynamics in each operation.

[PMQC 2/2, p. 7-10]

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting. During the discussion, comments were made on display.

Participant C-1
For me, the most important one would be number eleven, this concept of core earnings. There are things which we consider unusual or extraordinary that are not classified that way. I think it's more a rule change. Now maybe it doesn't need to be a rule change, maybe additional disclosure on it, but if I had to go through this whole list, that would be the most important thing to me. [Also included in 15] **[TC 3/11, p. 69]**

Participant C-4
I had three circled, one being the core earnings. We find it very difficult to pick out what core earnings truly are on a consistent basis. I also had ten; we see a real need to get more information about off balance sheet activity including particularly operating risks. And disclosure of measurement uncertainties is the final area that I circled. [Also included in 15 and 19] **[TC 3/11, p. 69]**

Participant C-12
I think the number 11 concept of core earnings is important to the analysis. I'm not sure that it's something that you're going to be able to give me. If the object is to give me the detail in the financial statements so that I can, in the end, make my own judgment as to what is core earnings, that's fine. On the other hand, if the object is to do what a lot of foreign institutions do and say this is core earnings, I'm always going to adjust that number. This year in [name deleted's] numbers I'm taking out $170 million of foreign exchange gains in the third quarter because it was a great quarter and they've said it was about that much over and above the normal quarter. My second choice is number 13, accounting for financial instruments. I'd also put in a vote for number one, statistics on the economy. Maybe in general, maybe when it comes to banking in terms of local economy, a lot of my decisions don't make it worth my while to figure out what's going on in the local economy in whatever state, whatever city, whatever regions. And one of the things that foreign banks do that's very good is they give me that information. They tell me what rates are doing, which I need to know, they tell me what real estate prices are doing, they tell me what lending volume is doing. I could go out and do that myself but often the decision I'm making doesn't justify doing it. And it's a great help to me to have it in the annual report. [Also included in 13 and 15] **[TC 3/11, p. 72]**

Participant C-10
9 (display), 11 (core earnings) and 12 (interim reporting). Basically try to improve cash flow information. Under nine, I think there's too much alternative uses here. I'd like to get more consistency. And like core earnings, one of the things that we're always doing is pulling out

depreciation, normal depreciation and extraneous or non-normal. Most companies will just lump it in one figure. On interim reporting I just think that we have to keep hitting on this issue with you folks, otherwise you'll back up on us. [Also included in 5(d) and 15] **[TC 3/11, p. 72]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 10--Income statement display

a. Does the information in the income statement, related notes, and MD&A generally provide you with sufficient information about nonrecurring and unusual tansactions and events?

Yes *1* No *6*

b. If you checked "no" in 10a, please indicate your relative preference for the following items, each of which relates to display on the income statement of nonrecurring or unusual amounts, by marking:

H - the item offers high potential for helping you in your work
M - the item offers moderate potential for helping you in your work
L - the item offers very low or no potential for helping you in your work

(If you checked "yes" in 10a, please skip to question 10c)
rank
H, M, or L

5(a). **Income Statement, including Core Earnings and Comprehensive Income—Page 31**

	High potential	Moderate potential	Low or no potential
Display separately the effects of nonrecurring or unusual transactions or events, particularly those that increase income, based on management and auditor judgments about which transactions or events are nonrecurring or unusual.	*3*	*2*	*1*
Display separately the effects of nonrecurring or unusual transactions or events, particularly those that increase income, based on specified criteria to identify the nonrecurring or unusual transactions or events. (Those critieria could be based on, for example, (1) the type of transaction, (2) the size of the impact, or (3) the frequency of the transaction or event.)	*6*		
Provide more detail about restructuring charges. That detail should distinguish between the cash and noncash portions of the charge and perhaps the tax effects of the various components.	*5*	*1*	
Provide more detail of items in the other income and expense caption(s) and nonoperating captions, using a materiality threshold that is much lower than currently used in practice.	*3*	*3*	
Something else. Please describe. *Participant I-8*: Unusual distributor ordering and stocking either of a new product or in advance of a price increaseon an existing product. Particularly where subsequent sales to reflect "move through" are likely to be well below the inventorying period. *Participant I-12*: Extra high. For my earnings models, I have above-the-line categories for recurring, nonrecurring items (sale of subsidiary, gains/losses on mortgage backed securities, etc.) Perhaps something along these lines might be helpful.	*2*		

c. Please help us understand the types of information that you would find useful about unusual or nonrecurring events by indicating your preference for the following items:

rank
H, M, or L
as in question 10b

	High potential	Moderate potential	Low or no potential
a brief description of each nonrecurring or unusual transaction or event or group of similar transactions or events	*7*		
the effects on revenues and expenses of nonrecurring and unusual transactions or events that affect both	*7*		
the tax effects of nonrecurring and unusual transactions or events	*5*	*2*	
the effect only on net income of nonrecurring and unusual transactions or events	*1*	*3*	*3*
aggregated amounts resulting from nonrecurring and unusual transactions or events taken as a whole	*1*	*5*	*1*
separate disclosure of the effects of each significant nonecurring or unusual item or event, or each group of similar transactions or events	*6*		*1*
Something else. Please describe. *Participant I-6*: All items should be listed separately, but in a fashion that would quantify the total amount involved.	*1*		

d. Does the information in the income statement, related notes, and MD&A generally provide you with sufficient information about the operations of the company's business?

Yes *1* No *6*
Participant I-12: We analysts can't get enough information

e. If you checked "no" in 10d, please indicate your relative preference for the following items, each of which relates to display on the income statement that could possibly be helpful in understanding the operations of the company's business:

rank
H, M, or L
as in question 10b

	High potential	Moderate potential	Low or no potential
Divide operating expenses into fixed, semi-variable, and variable categories	*4*	*1*	*1*
Divide operating expenses into controllable and noncontrollable categories	*2*	*2*	*2*
Divide operating expenses into discretionary and non-discretionary categories	*3*	*2*	*1*
Display the types and amounts of costs included in certain major captions (for example, cost-of-sales broken down by purchased materials, salaries, fringe benefits, occupancy costs, property taxes, and other major components of costs).	*5*	*1*	
Display selling expenses separately from general and administrative expenses.	*6*		
Display the portion of cost-of-sales and SG&A expenses that is depreciation.	*5*	*1*	
Indicate separately the portion of costs and expenses that relate to employees versus those that do not.	*3*	*3*	
Something else. Please describe. *Participant I-11*: More responsive explanation of changes in MD&A ("cost of goods was up because sales were up" is not helpful.	*1*		

[PMQI 12/9 and 1/13, p. 16-19]

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 12

In prior meetings, investors have used the term core earnings when discussing their methods for valuing companies. We presume that by core earnings investors generally mean:

Core earnings - the portion of a company's reported historical earnings that are stable and recurring and that provide a basis for estimating its expected repeatable average earnings over a span of future years. Thus, core earnings excludes those portions of historical earnings that are infrequent, nonrecurring, or otherwise unusual enough to be

distinguished from that portion of earnings that results from the usual operations of the company.

a. Does the foregoing accurately describe your definition of core earnings?

Yes *4*
No 1

If not, how should the description be changed?
Participant I-16: Accounting should not attempt to report stable earnings. It should report what actually happened during the period, while identifying (non-recurring events which actually happened during the period) and corrections of prior misallocations which are part of recurring items - but not of the current period.

You have an exceedingly oversimplified conception of core earnings. It is in the mind of the beholder. It is a normalized trend- not a stable level. It relates to specific business operations, not to an overall company. Disaggregation in disclosure would assist investors in their estimation of core earnings. Valuation and earning power are forward looking- not historically based.

b. To what extent do investors' judgments about core earnings differ? That is, if a dozen investors independently determined a company's core earnings, would the resulting twelve measures of core earnings likely be: (Please check one.)

• nearly the same amount? *Participant I-9:* Except for very cyclical or volatile industries like metals or hogs	*1*
• different amounts showing a tendency to cluster?	*3*
• different amounts scattered about, showing no predictable pattern?	
• something else? Please explain. *Participant I-16:* It depends upon the volatility of the company's business.	*1*

c. Core earnings is a concept of financial analysis and not currently of financial accounting. If forced to choose between the following, which one would you choose, and why? (Please check one.)

Financial accounting should be updated to include the concept of core earnings. That is accounting standard setters should define core earningsand require that the amount be reported as a separate caption on the face of the income statement. Amounts that are excluded from core earnings should be separately displayed in the income statement or disclosed in the related notes.	*1*
Determining core earnings should remain the job of financial analysis and not financial accounting. Thuscore earnings should not be separately reported on the face of the income statement. Howeverfinancial reporting should help investors determine core earnings for themselves. Thus standard setters should define infrequent unusual and nonrecurring transactions or events and require that the effects of those transactions or events be separately displayed in the income statement or disclosed in the related notes.	*4*
Please briefly describe why you chose one method and rejected the other.	*Participant I-16:* Core earnings are more subjective than reported earnings should be. Adequate disclosure would allow individuals to reach their own independent estimates of "core earnings." In some cases ([name deleted] et al) there would be no agreed value- or anything close to agreement. *Participant I-9:* Key is financial reporting should help investors determine core earnings for themselves. *Participant I-11:* Core earnings is an analytical concept, not an accounting concept. Analytical judgements differ, and properly so (although sophisticated analysts' judgements should tend to cluster most of the time). Neutral, reliable, consistent financial statements provide a basis for analysis; "analyzed" financial statements don't.

d. Please answer the following questions about potential factors that investors use to distinguish between core and non-core earnings.

•Is frequency of occurrence a condition for including a gain or loss in core earnings?

Yes *5*
No

If so, how infrequently should a particular transaction or other event occur for you to exclude its financial effect(s) from core earnings?

Not more often than once in every eight or ten years	*1*
Not more often than once in every six or seven years	
Not more often than once in every four or five years	*1*
Not more often than once in every two or three years	*1*
Other. Please explain.	*Participant I-16:* It is impossible to give a precise rule. *Participant I-11:* This is not a simple issue. Consider a manufacturing company with several parcels of land it acquired for planned but since abandoned expansion. If it sells off one parcel a year for two, thre, four, or X years, does this make gains/losses "core"? I don't think so. I think relevance to continuing business operations has to be taken into account. With that major caveat, I'd say that every 4-5 years is a good place to start.

•Is relationship to an ongoing major line of business of a company a condition for including a gain or loss in core earnings?

Yes *3*
No *1*

If so, would you usually consider gains or losses resulting from each of the following to be nonoperating and exclude them from core earnings?

♦Investment activities that are peripheral to a company's manufacturing operations but involve recurring transactions and price changes and result in significant gains and losses and cash flows

Yes *3*
No *1*

♦Impairment of plant and equipment assets of a manufacturing company that has suffered a more-or-less constant decline in demand for its product

Yes *3*
No *1*

♦Disposal of plant and equipment assets of a manufacturing company whose products require regular modernization and upgrading of the manufacturing process

Yes *2*
No *2*

♦Restructuring of a manufacturing company involving laying off employees for what is expected to be a long period

Yes *2*
No *1*

♦ ________________________________ Please explain the reason for each **No** answer.
Participant I-16: 1) I would estimate core earnings for specific businesses- not for a diversified company. 2) An analyst often has to reallocate "non-recurring costs" - they are often ordinary expenses that were undersestimated in prior periods.
Participant I-11: Recurring investment income from a company with large cash balances is part of its business, and reflects management's decisions as to the continuing deployment of those assets. Similarly, disposal of plant and equipment is part of being in, say, the semiconductor manufacturing business. Restructuriongs should be exceptional events - if they become commonplace, that raises some major non-accounting issues about management - all the more reason to red-flag the issue. Similarly, if a management sees steadily declining demand for a product, it should adjust its investment and adjust depreciation to reflect a realistic useful life. That's part of running a business!

•What do you do if those two conditions are in conflict—if a transaction or event is essentially the same as the operations of a company but occurs only infrequently or otherwise gives unstable results? For example, would you include the financial effects of each of the following in the company's core earnings?

♦Sale of a large order of a company's product to the U.S. Department of Defense if the last sale of that kind was seven years ago and prospects for another within the next five years are virtually nil

Yes *1*
No *3*

◆Fluctuating investment gains and losses of an insurance company if an investment portfolio is an essential part of the company's operations and the volatility of the returns is inherent in investments in equity securities

Yes *2*
No *2*

◆ Please explain the reason for each **No** answer.

Participant I-16: You are confusing two concepts: 1) Results of operations of a specific period, 2) Normalized or trend or average earnings. Accounting should focus on #1, financial analysis deals with #2.
Participant I-9: Accounting should not try to make an unstable earnings pattern appear stable. Its job is to point out significant items that are unlikely to recur so that past results do not mislead investors, who are mainly valuing companies' future prospects.

Participant I -11: I'm not sure I mean my answer to #2. In an ideal world an insurance company would match its portfolio to its actuarial risk- especially a life insurance company. Gains and losses from "static" in actuarial experience should be ignored. In a world of "go-go" portfolio management, there's an additional risk element in the business as it's being managed. On further reflection, since the world is more nearly "go-go" than "ideal", perhaps they should be recognized.
[PMQI 3/17, p. 19-25]

QUESTION 13

Under current rules, in a handful of circumstances, amounts are charged or credited directly to shareholders' equity and bypass the income statement. One example is translation gains and losses resulting from changes in exchange rates. Supporters of the practice argue that it removes undesirable volatility from the income statement. The following statements relate to the desirability of recording certain gains or losses directly in equity. Please indicate your degree of agreement or disagreement by marking the applicable letter(s).

SA - **Strongly Agree**
A - **Agree**
N - **Neutral**
D - **Disagree**
SD - **Strongly Disagree**

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
No gains or losses should be charged or credited directly to equity. All of those amounts should be recorded in the income statement.	*2*		*1*		*2*
The amounts that are currently charged directly to equity should be reported in income. However, they should be separately displayed below the caption titled net income and above a new caption titled comprehensive income.		*1*	*2*	*1*	*1*
The practice of reporting certain amounts directly in equity should be retained. However, the practice should not be expanded to include additional amounts that are currently recognized in income.		*2*	*2*	*1*	
The practice of reporting certain amounts directly in equity should be expanded to reduce undesirable volatility in the income statement. Please describe which items that are currently reported in income should be reported directly in equity.			*4*		*1*

Participant I-11: I haven't made up my mind on this one- it begins to make the face of the P&L unpleasantly complex.

[PMQI 3/17, p. 25-26]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 13

It is clear users are interested in improvements which would enhance identification of *core earnings and related cash flows*. It is not clear *what improvements* would best serve users needs. Please indicate your agreement or disagreement with the following approaches to identification of core earnings and cash flows. Respond using the following:

5(a). Income Statement, including Core Earnings and Comprehensive Income--Page 40

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

SA-3,A-4,N-3,D-3

__ a. Income statements and cash flow statements should be formatted so that each *reports a subtotal* of "Core Earnings" and "Core Cash Flows".

Participant C-21: Either method (a. or b.) would be acceptable.

A-5,N-2,D-5,SD-1

__ b. Current income statements and cash flow statements should not be reformatted, but *supplemental disclosures* should be included that provide breakdowns of revenues and expenses (cash inflows and outflows) between core amounts and other amounts.

SA-1,A-5,D-6,SD-1

__ c. It is not necessary to report a distinct amount as core earnings or cash flows. What is required is improved disclosure of unusual amounts by *redefining "unusual" for accounting purposes*. Thus, users can make their own judgements about which unusual items, if any, should be included in core earnings.

Participant C-14: This would work.

Participant C-21: This would be more difficult for user and consistency would not be maintained.

A-2,N-3,D-6,SD-2

__ d. It is not necessary to report a distinct amount as core earnings or cash flows. What is required is improved disclosure of unusual amounts. Accounting standards should not define "unusual". Instead, *management should make its own determination* of what is reported as "unusual". Thus, users can make their own judgements about which unusual items, if any, should be included in core earnings.

Participant C-14: Too much discretion can lead to misleading figures.

Participant C-21: No.

SA-1,A-8,N-2,D-2

__ e. Allowing management to determine what is "unusual" *provides too much risk* that only expenses, not revenues, will be considered "unusual".

Participant C-11: Auditors would be involved here.

A-1

__ f. Something Else. Please Describe:

Participant C-11: Apart from unusual items, another major category is valuation changes - realized and unrealized - caused by interest rate or market value changes for financial instruments.

Participant C-4: Standardize income statement and cash flow statement - operating section to include the same breakdowns - Rev, G.P. and core earnings.

Participant C-17: C - Unusual/extraordinary charge and income shall be carefully defined and cash vs non-cash charges clearly identified.
[PMQC 3/11, p. 20-22]

QUESTION 14

In determining core income for a company, to what extent would different creditors include and exclude the same components of net income? That is, if a dozen creditors independently adjusted a company's net income to determine its core income, would the resulting twelve measures of core income likely be (please check *ONE*):

_0_ a. The same amount

_9_ b. Different amounts showing a tendency to cluster

Participant C-21: Hopefully.

_2_ c. Different amounts showing no predictable pattern

_2_ d. Something Else.
Please Describe:

Participant C-14: Everyone's intended use of the information and subsequent conclusions would be very close but the method of adjusting the numbers would vary, i.e., I deduct cap ex from cash flow - others may not but we all look at it and use it the same way before we draw our conclusions.

Participant C-11: Opinions would vary depending on what elements a creditor thinks are critical, by economic or cyclical circumstances, types of operation, etc.

Participant C-4: Close to the same amount, depending on the creditors level of understanding.
[PMQC 3/11, p. 22]

[Context] For companies in the precious metals business, the Mining Industry Subcommittee of the AIMR Corporate Information Committee would like to see improvements in reporting the following:

[The Oil Industry Subcommittee of CIC] note[d] the wide disparity that very often exists between the reported earnings for many oil companies and true operating income that provides a basis for future expectations. With a large number of major corporations in the midst of major restructuring moves, the impact from nonrecurring events can completely distort reported earnings and conceal a company's true operating position. If professional analysts are confused with some of the reported earnings data we can only assume the individual investor is even more so. [Also included in 15] **[AIMR/CIC91, p. 1]**

Most [CIC] subcommittees agree . . . [that] the following suggestion seems appropriate: [Also included in 1(b), 2(b), 2(c), 3(b), 3(d), 5(d), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3]**

- Segregation of the financial impact from nonrecurring items (asset sales, write-offs, etc). [Also included in 1(b) and 16(b)] **[AIMR/CIC92, p. 4]**

Pronouncements are concerned with balance sheet presentation with little attention to how results are reported in the income statement. AIMR's accounting committee has appreciated the attention the FASB has been giving the balance sheet but believes that the income statement is of equal importance. The committee supports the idea of comprehensive income as defined in Concepts Statement No. 6, but believes that the FASB should focus more attention on what is reported in the intermediate components of comprehensive income such as gross margin, operating income, income from continuing operations, and earnings as well as the basic components of comprehensive income, revenue, expense, gains, and losses. **[AIMR/FAF91, p. 13]**

The objectives of financial statements are to provide information useful in:

investment and credit decisions,
assessing cash flow prospects, and
evaluating enterprise resources, claims to
those resources, and changes in them.

[AIMR/FAF91, p. 14]

An income statement that contains only a few lines of aggregated information (the largest of which is frequently "other income and expense, net") does not achieve any of these objectives. **[AIMR/FAF91, p. 14]**

[Background] *The Financial Industry--Banks, Thrifts, Insurance Companies, and Securities Firms* is the second in a series of AIMR Industry Analysis seminars and proceedings. The series was conceived by Charles D. Ellis, CFA, to provide educational material on the nuances of individual industries from the perspective of security analysis. . . . Each seminar is built around an analytical framework that identifies the key factors to consider in conducting an effective analysis of the industry and that highlights the specific interrelationships that underlie sound valuation decisions. . . . The speakers at the seminar, whose presentations this proceedings reproduces in full, are among the leading specialists in financial services industry analysis. **[AIMR FINSER INDUSTRY, p. i]**

[According to Picoult,[1]] the revenue mix is the most important item on the income statement. Analysts should determine what portion is premiums, what portion is net investment income, and what is "other" income. The sources of the other income figures are important. For example, the company may have separate operations or subsidiaries that generate other income. For many holding companies, just determining what they own is difficult; the information may be buried in the other income category, and sometimes it is worthwhile to go digging. [Also included in 1(b) and 1(c)] **[AIMR FINSER INDUSTRY, p. 97]**

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(b), 2(c), 4, 5(b), 5(d), 5(c), and 13] **[KPMG BANK STUDY, p. 39]**

- Preferred historical cost financial statements supplemented with fair value disclosures [Also included in 4, 5(b), and 5(c)] **[KPMG BANK STUDY, p. 39]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

[One analyst] could not see how fair market value accounting could be implemented for real estate entities. The key issue for real estate firms is the tremendous variance in accounting policies towards expensing items versus capitalizing items. He said that earnings per share is a useless number and that cash flow per share is paramount. He defines recurring net income or net funds from operations as net rents minus G&A minus interest. He feels a meaningful ratio is this number (funds from operations) divided by historical costs of all properties. [Also included in 1(b), 1(c), and 4] **GOLDMAN, p 1]**

[One analyst] wants to know the core earnings of [a] bank. She eliminates unusual and nonrecurring items. She does not use the cash flow statement because she believes bank earnings and cash flow results are very close. She does not use the pension footnote because she cannot understand it. All she wants to know about pensions are the assumptions and if a plan is over or under funded. She does not understand tax accounting or the tax footnote. [Also included in 1(b)] **[GOLDMAN, p. 2]**

[One analyst] would like income to be determined more by cash activities than by accrual. He would like more disclosure and reconciliation between cash income and GAAP income every quarter. He feels that the standards are too loose in the allowance of one time charges. [Also included in 1(b) and 15] **[GOLDMAN, p. 4]**

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[1] Myron M. Picoult, Managing Director, Senior Insurance Analyst, Oppenheimer & Company, Inc.

From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 1(b), 2(c), 2(d), 3(c) 4, 5(c), 6, 8(a), 9, 11(b), 11(c), and 15 **[BETRIOU, p. 1]**

It is likely that the objectives of all accounting data users do not coincide. As far as they are concerned, [foreign] financial analysts essentially need data which reflects the economic reality of entities they examine (groups or companies). Further progress is still required and we have broken this down into . . . categories: [Also included in 1(b), 4, 6, 8(a), 9, and 15] **[BETRIOU, p. 3]**

- Exceptional earnings are still too often under detailed. The distinction made with regular profit permits a keener analysis of the past and future profitable developments. [Also included in 1(b) and 15] **[BETRIOU, p. 3]**

5.a.45 **Where the Art of Accounting Is Headed**

As in 1980, the 1985 study probed some much discussed possible trends that might be shaping up in accounting practice and financial reporting. In each case, each person interviewed was given a written description of the possible development and then asked how likely it was to take place and then, if the change did take place, would it be positive or negative.

Table 2.6

POSSIBLE DEVELOPMENTS IN THE FUTURE STATE OF THE ART OF ACCOUNTING

	Likely to Take Place		Positive or Negative Development			
	1985	1980	1985		1980	
	%	%	Positive %	Negative %	Positive %	Negative %
Financial reports in the future will give less attention to earnings per share and much more emphasis to components of earnings, such as revenues and operating income.	83	78	82	11	71	19
Return on investment will take over from earnings per share as the key measure of the performance of an enterprise.	69	67	69	17	64	23
As inflation continues, current cost measurements will gradually become more important than historical cost measures, because earnings measures based on current costs will better allow investors to make assessments of the earning powers of enterprises.	68	93	52	39	77	17
Fixed and variable costs will be broken out in financial reporting to show the impact that management decisions have in areas such as maintenance, advertising and other selling expenses, and research and development.	57	67	65	28	60	31
Data such as earnings forecasts will be required in financial reports.	52	68	38	55	36	58
Data such as reporting of responses to social responsibilities will be required in financial reports.	29	48	24	64	23	68

The most likely and most positive potential change that is believed to be taking place is the perceived replacement of earnings per share as the pivotal key to financial reports by components of earnings, such as revenues and operating income. A sizable 83% believe this is likely to happen and a big 82-11% majority would welcome such a change, up from a comparable 71-19% who felt that way in 1980.

The only other scenario that is viewed as more likely now than it was in 1980 is that earnings per share will be replaced by return on investment as the key measure of performance, a move that would be looked on favorably by a 69-17% margin, up slightly from 64-23% who felt that way in 1980.

Observation: *It is evident that earnings per share is fading fast as the key measurement of the success of management of corporations. The most likely replacement, in the view of these key players in the financial community, are reports on components of earnings, such as revenues and operating income. Such a change would be widely welcomed in all sectors.*

[HARRIS]

5.a.46 Following is a breakdown by respondents on possible developments in the future state of the art of accounting.

Table 2.7

POSSIBLE FUTURE DEVELOPMENTS: BREAKDOWN BY RESPONDENTS

Q.8A—In the future, how likely is it that the following developments will take place . . . (READ EACH ITEM)?

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
As inflation continues, current cost measurements will gradually become more important than historical cost measures because earnings measures based on current costs will better allow investors to make assessments of the earning powers of an enterprise														
Highly likely	22	6	13	27	21	39	26	24	27	20	27	10	37	47
Somewhat likely	47	44	37	42	39	44	57	51	47	53	53	61	55	35
Hardly likely	31	50	51	27	39	15	16	22	27	20	20	29	8	18
Not sure	1	–	–	3	–	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Fixed and variable costs will be broken out in financial reporting to show the impact that management decisions have in areas such as maintenance, advertising and other selling expenses, and research and development														
Highly likely	12	1	5	12	4	29	26	4	7	7	–	23	11	12
Somewhat likely	45	35	48	39	46	41	54	40	40	40	40	39	58	59
Hardly likely	42	63	46	45	50	27	20	53	53	47	60	35	32	24
Not sure	1	1	1	3	–	2	–	2	–	–	–	–	–	6
No answer	*	–	–	–	–	–	–	–	–	–	–	3	–	–
Return on investment will take over from earnings per share as the key measure of the performance of an enterprise														
Highly likely	24	23	29	30	25	27	30	9	7	13	7	23	13	29
Somewhat likely	45	49	42	33	54	51	51	36	20	40	47	52	47	18
Hardly likely	30	28	29	33	21	22	18	51	67	40	47	23	37	53
Not sure	1	–	–	3	–	–	2	4	7	7	–	3	3	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Data such as earnings forecasts will be required in financial reports														
Highly likely	9	1	10	3	4	7	10	13	20	13	7	16	13	18
Somewhat likely	43	44	49	33	39	29	43	38	33	47	33	48	58	47
Hardly likely	47	55	41	61	54	61	48	47	47	33	60	35	29	35
Not sure	1	–	–	3	4	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

5.a.47

Table 2.7 (continued)

POSSIBLE FUTURE DEVELOPMENTS: BREAKDOWN BY RESPONDENTS

		Large Public Companies						Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Data such as reporting of responses to social responsibilities will be required in financial reports														
Highly likely	4	–	5	3	7	7	8	2	–	–	7	–	5	6
Somewhat likely	25	27	29	15	21	34	18	9	7	7	13	19	39	35
Hardly likely	70	73	66	79	68	56	74	87	93	87	80	81	55	59
Not sure	1	–	–	3	4	2	–	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Financial reports in the future will give less attention to earnings per share and much more emphasis to components of earnings, such as revenues and operating income														
Highly likely	31	14	25	27	36	37	48	31	33	20	40	55	34	24
Somewhat likely	51	64	47	45	57	49	49	51	53	53	47	32	53	65
Hardly likely	15	21	25	24	7	12	2	11	7	20	7	13	13	12
Not sure	2	1	3	3	–	2	2	7	7	7	7	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

Table 2.8

WHETHER FUTURE DEVELOPMENTS WOULD BE POSITIVE OR NEGATIVE CHANGES: BREAKDOWN BY RESPONDENTS

Q.8B—Would the following be a positive or negative change in the state of the financial reporting art . . . (READ EACH ITEM)?

		Large Public Companies						Large Accounting Firms						
	Total	Chief Exec. Officers	Chief Financial Officers	Small Public Companies C.E.O.	Private Companies C.E.O.	Investment Institutions	Bank Lending Officers	Total	Executive Partners	Technical Partners	Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
As inflation continues, current cost measurements will gradually become more important than historical cost measures because earnings measures based on current costs will better allow investors to make assessments of the earning powers of enterprises														
Positive change	52	29	30	55	57	66	82	44	40	40	53	45	82	76
Negative change	39	63	58	36	39	24	16	44	47	40	47	45	5	12
No change	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Not sure	8	5	10	9	4	10	–	11	13	20	–	10	13	12
No answer	1	3	1	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

5.a.48

Table 2.8 (continued)

WHETHER FUTURE DEVELOPMENTS WOULD BE POSITIVE OR NEGATIVE CHANGES: BREAKDOWN BY RESPONDENTS

	Total	Large Public Companies: Chief Exec. Officers	Large Public Companies: Chief Financial Officers	Small Public Companies (C.E.O.)	Private Companies (C.E.O.)	Investment Institutions	Bank Lending Officers	Large Accounting Firms: Total	Large Accounting Firms: Executive Partners	Large Accounting Firms: Technical Partners	Large Accounting Firms: Audit Partners	Small Accounting Firms	Academics	Financial Media
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Fixed and variable costs will be broken out in financial reporting to show the impact that management decisions have in areas such as maintenance, advertising and other selling expenses, and research and development														
Positive change	65	50	53	45	54	76	93	62	60	67	60	61	79	94
Negative change	28	44	41	39	25	20	7	29	27	27	33	29	11	6
No change	*	–	–	–	–	–	–	2	7	–	–	–	–	–
Not sure	7	5	5	15	21	5	–	7	7	7	7	6	11	–
No answer	1	1	1	–	–	–	–	–	–	–	–	3	–	–
Return on investment will take over from earnings per share as the key measure of the performance of an enterprise														
Positive change	69	76	72	67	86	71	75	58	47	53	73	74	47	53
Negative change	17	12	15	27	7	22	8	27	33	27	20	13	24	35
No change	1	1	1	–	–	–	–	–	–	–	–	–	3	–
Not sure	12	10	10	3	7	7	16	16	20	20	7	13	26	12
No answer	1	1	1	3	–	–	–	–	–	–	–	–	–	–
Data such as earnings forecasts will be required in financial reports														
Positive change	38	19	25	33	25	32	51	51	60	33	60	52	66	65
Negative change	55	73	71	67	71	61	38	44	40	60	33	42	24	24
No change	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Not sure	6	6	3	–	4	7	11	4	–	7	7	6	11	12
No answer	*	1	1	–	–	–	–	–	–	–	–	–	–	–
Data such as reporting of responses to social responsibilities will be required in financial reports														
Positive change	24	26	22	18	29	24	21	20	20	20	20	16	37	24
Negative change	64	64	67	79	64	56	64	64	60	60	73	74	37	71
No change	1	–	–	–	–	–	2	2	7	–	–	–	3	–
Not sure	11	8	10	3	7	17	13	13	13	20	7	10	24	6
No answer	1	3	1	–	–	2	–	–	–	–	–	–	–	–
Financial reports in the future will give less attention to earnings per share and much more emphasis to components of earnings, such as revenues and operating income														
Positive change	82	74	70	76	86	80	98	89	80	87	100	84	82	94
Negative change	11	14	19	21	–	10	–	4	13	–	–	13	11	6
No change	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Not sure	7	10	10	3	14	10	2	7	7	13	–	3	8	–
No answer	*	1	1	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

5(b). Balance Sheet

As part of its oversight activities, the Oversight Committee of the Financial Accounting Foundation interviewed and requested written comments (collectively, "the interviews") from thought leaders among the FASB's constituencies. There were 107 interviews in total, including 12 with representatives of financial statement users and 17 with regulators (a special class of financial statement users). **[FASOversight, p. 1]**

While the interviews were not designed to elicit criticisms of financial reporting, in general, or to identify the needs of users of financial information, interviewees did comment on those matters. **[FASOversight, p. 1]**

Following is a summary of the principal comments received [on the subject] from users and regulators relating to . . . the needs of users. **[FASOversight, p. 1]**

- Recognition of financial transactions in the basic financial statements is preferable to disclosure only. **[FASOversight, p. 2]**

The APC [Accounting Policy Committee] has considered and expresses below its opinions on a number of specific issues affecting financial accounting standards and financial reports. The APC believes that the following items should be included in the single body of accounting concepts, standards, principles and methods: **[RMA90, p. 5]**

- Liabilities of a company are legal obligations to creditors to be paid, in most instances, at a specific future time (maturity date) or at the happening of a specific future event such as failure to comply with one or more loan covenants (default). Such obligations should be included on the balance sheet until the credtior has been fully satisfied and there is no continuing recourse to the debtor with respect to the debt. Liabilities should be classified as either current or noncurrent on the basis of the written terms of the borrowing document, including any amendments. A debt due within one year should be classified as current regardless of the probability that it will be renewed, refunded, or otherwise not be repaid within that period. **[RMA90, p. 7]**

- Financial assets and liabilities represent agreements to convey specific amounts of cash from borrowers to lenders at specific future dates. Interest represents the difference between the amount borrowed and the aggregate amount to be repaid. The rate of interest implicit in a financial obligation is established at the inception of the agreement and is called the historic rate. Interest revenue (expense) should be reported periodically on the income statement by applying the historic rate to the unpaid balance of the obligation at the beginning of the period. Interest accrued in excess of a period's payments should be added to the debt; payments in excess of interest accruals should be deducted. [Also included in 4] **[RMA90, p. 9]**

  In cases where the initial borrowing involves consideration other than cash, the historic rate of interest should be estimated by reference to rates of interest on debt instruments of similar duration and risk. In all cases, there should be disclosure of information that

allows financial statement users to know or calculate the contractual amounts of cash payments required by the obligation, both periodic ("coupon") and final ("face"). [Also included in 4] **[RMA90, p. 9]**

The balance sheet receives far less attention than the income statement [by equity sell-side analysts], and the occurrences of balance sheet type words and phrases occur far less frequently [in analysts' reports]. Much of the attention to balance sheet items comes in the form of liquidity and cash flow analysis. For example, reports may assert balance sheet strength on the basis of a company's free cash flow. While several income statements are almost always presented, many reports contain only summary balance sheets. [Also included in 1(b), 1(c), and 5(c)] **[PREVITS, p. 17]**

Long term productive asset values on the balance sheet are nearly always evaluated at cost [by equity sell-side analysts]. The effect of inflation on such assets rarely is explicitly considered. However, for some companies, a supplemental analysis of assets' market value is conducted. This is undertaken for firms analysts consider to be poorly understood by other analysts and investors, and particularly where latent significant off-balance-sheet or hidden assets may exist. [Also included in 1(b), 1(c), and 4] **[PREVITS, p. 17]**

[A]nalysts asserted that a cable television company had substantial off-balance-sheet assets in the form of residual payments to be received in the future. They calculated the value of the company using several methods, one being the present value of the anticipated cash flows from these residuals. One analyst stated that "balance sheet recognition of . . . hidden asset values . . . will occur in future years". Other examples include inventory and reserve valuations of extractive industry companies. For instance, in gold mining companies, a market value appraisal is included of the reserve values by ore type. [Also included in 1(b), 1(c), 4, and 5(c)] **[PREVITS, p. 17]**

[Equity sell-side] analysts periodically examine the quality of assets, particularly in troubled industries such as banking and insurance. Here, attention is paid to nonearning assets, non-performing assets, and the quality of assets (loan portfolios) and investments. [Also included in 1(b) and 1(c)] **[PREVITS, p. 17]**

Liabilities are usually addressed in a summary fashion, often in a simple analysis of the capitalization of the corporation. Extensive attention to liabilities usually only occurs for companies that are highly leveraged and typically in conjunction with a cash flows analysis. [Also included in 1(b), 1(c), and 5(c)] **[PREVITS, p. 17]**

Over the span of the FASB's existence, its pronouncements have become more and more oriented to the statement of financial position. This is meant as an observation, not criticism. [Also included in 5(a) and 5(c)] **[AIMR/FAPC92, p. 41]**

Perhaps the most apt example is FAS 109, "Accounting for Income Taxes." It fixes its attention on identifying at a point in time those transactions and events that are deemed to have future tax consequences, then measuring the effect on financial position of the benefit(s) and/or obligation(s) resulting from them. Their effect on periodic income is calculated only as the necessary consequence of those financial position assessments. This is an approach opposite from the now-superseded Accounting Principles Board Opinion 11 in which the objective was to measure the deferred portion of the current period's provision for income taxes, with resultant balance sheet residuals called deferred tax liabilities and/or assets. [Also included in 5(a) and 5(c)] **[AIMR/FAPC92, p. 41]**

We applaud the efforts and accomplishments of the FASB in making balance sheet amounts more meaningful than before. Prior to FAS 109 (and its short-lived predecessor, FAS 96), deferred tax accounts on the balance sheet had little meaning since they were remnants of past income statements, whereas today they depict amounts that the enterprise expects to result in future cash flows. However, as FAS 109 and various other standards have been promulgated we feel that the development of the income statement has been neglected. We also feel as if more could be done to make cash flow statements more accurate and more useful to analysts. The purpose of this short section is to summarize our views on those matters: (a) with respect to the income statement, primarily to summarize information scattered throughout earlier parts of this report; (b) with respect to cash flow statements to introduce new material. [Also included in 5(a) and 5(c)] **[AIMR/FAPC92, p. 42]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on the types of information investors use to achieve their objectives, some participants referred to some aspects of balance sheet display.

Participant I-7
I can ask for it. Let me follow with another point. Especially in the financial area, if companies are setting up reserves, I would like to see when the reserves are used. I would like a stream of information as the assets are written off about what part of the reserves has been applied against those assets. [Also included in 1(b) and 13] **[TI 10/16, p. 45-46]**

Participant I-12
Any financial business ought to be reporting an average balance sheet and the accounting for the loss reserves. The year end balance sheet can totally distort the entire enterprise. [Also included in 1(b)] **[TI 10/16, p. 46]**

Participant I-1
The point about the treatment of the reserves is an excellent one. Breaking out the reserves from the general accruals category would be worthwhile because when you do have reserves year after year, you don't know what is in there. And as they are applied, some information as to how they are applied to specific assets and how they are relieved is a terrific idea. [Also included in 1(b)] **[TI 10/16, p. 46]**

In the way of additional information, a break up between maintenance and gross capital expense and the same for R&D would be worthwhile. On the revenue side, price volume information is provided by some companies; for example, supermarkets provide that information. [Also included in 1(b) and 13] **[TI 10/16, p. 46]**

Participant I-7
Especially in this kind of environment where an increasing number of companies are taking significant charge offs that can go in excess of $1 billion, it gets back to the cash flow issue. At the time of the charge off, it's a non-cash flow issue, but to the extent that a good portion of those dollars are going to be used either to lay people off over a period of time or to physically close plans, I would like to get some sense of how that cash has been used out of that restructuring charge. [Also included in 1(b)] **[TI 10/16, p. 56]**

Participant I-1
It goes back to relieving the reserve account. [Also included in 1(b)] **[TI 10/16, p. 56]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
Let's move on to balance sheet display. As you know, under current rules, the balance sheet is classified by type of asset or liability, which are reported in rough order of liquidity or timing of payment. That display does provide information about the nature of the company's assets and liabilities, and the operation of its business, but perhaps better display could provide even more useful information. The meeting materials identified three areas in which better display might assist you. First, perhaps it could help you better understand uncertainties about the company's assets and liabilities. Second, perhaps it could assist your identification of unusual or nonrecurring items. And third, better balance sheet display could improve your insight into the company's business. The meeting materials provided some ideas in each of those categories. We are interested in your reactions to those ideas and other ideas that you have about balance sheet display that would be useful in your work. **[TI 1/13, p. 35]**

Participant I-14
I think the identification of past-due receivables, or the aging of receivables, would be very helpful in certain cases. **[TI 1/13, p. 35]**

Participant I-5
And also inventory. Those two things. **[TI 1/13, p. 35]**

Participant I-11
I'm not sure that presentation would be terribly helpful for the companies I follow. For a lot of industrial distribution companies, one of their principal roles is being a banker for their customers, and a lot of their receivables are "past due". But some sort of information about the quality of the receivables and the inventory, whether it is the basis under which the

reserves are established or historical experience, would help me get a better handle on how good those assets are. **[TI 1/13, p. 35]**

Participant I-12
One of the analysts in our shop is continually talking about how [name deleted] lends its inventories to car rental companies in essence. This creates real issues in terms of uncertainties and risks with regard to whether they're reporting true sales or not. There are a number of companies in a similar situation where what appears as sales are really contingent sales. This isn't fully disclosed. **[TI 1/13, p. 35-36]**

Committee/Staff/Observer
I think it's more than a display issue. It's something the SEC spends a lot of time on, that is, the appropriateness of revenue recognition. But I agree it's an issue. **[TI 1/13, p. 36]**

Committee/Staff/Observer
Any interest in showing operating assets separate from nonoperating assets on the balance sheet? **[TI 1/13, p. 36]**

Participant I-8
Yes, but I always assumed that we already did. Am I wrong in making that assumption? **[TI 1/13, p. 36]**

Committee/Staff/Observer
Yes, I think so. **[TI 1/13, p. 36]**

Committee/Staff/Observer
How disruptive would it be if you didn't have a balance sheet? [Also included in 5(c) and 11(c)] **[TI 1/13, p. 36]**

Participant I-8
Very. I can remember when quarterly balance sheets were a rarity. An income statement is worthless without a balance sheet. I would also love to see a quarterly cash flow statement. [Also included in 5(c) and 11(c)] **[TI 1/13, p. 36]**

Participant I-12
For a financial intermediary, you have to have a balance sheet because that's what generates the income and expense. **[TI 1/13, p. 36]**

Participant I-8
I would go one step further. I am seeing a lot of abbreviated balance sheets; current assets, current liabilities without the detail is worthless also. I really care about changes in inventory and whether some of the earnings are a result of inventory building, for example. So I find an abbreviated balance sheet inadequate. **[TI 1/13, p. 36-37]**

Participant I-7
My concern is that, for the most part, I don't take issue with the balance sheet display but it doesn't go far enough. If you were to include some of the suggestions we made, the balance

sheet would get very cumbersome. For example, on the liability side, I want to see information about letters of credit, off-balance-sheet contingencies. I don't know how you take an existing balance sheet and display that additional information without creating some viewable problems. So my position is not to fool with the current balance sheet display, but give us additional information in the footnotes. **[TI 1/13, p. 37]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, some comments were made on balance sheet display.

Participant C-4
I deal with a lot of smaller companies that probably a lot of you, revenues of $50 million and less primarily. Understanding core earnings is a key to our analysis, and I see no consistency in footnotes of supplemental information that we're receiving for customers of that size. One good example of what we need would be a cost of sales breakdown. That helps us assess cash flow, assess profitability, gross profits, and what's causing the gross profits to fluctuate, what's causing the cash flow to fluctuate. Overhead schedules are very important, and in percentage of completion accounting, open and closed job schedules are essential in determining the success and the prospects of the company that we're trying to grant credit to. [Also included in 5(a) and 15] **[TC 12/8, p. 27-28]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
On page 10 of the meeting materials, we had a similar discussion on the balance sheet. What do you look at in the balance sheet that is helpful in getting trend information for the future? For example, sometimes it's a qualitative analysis. Sometimes it's quantitative in terms of knowing how those numbers are going to roll off. But in any case, you look at the balance sheet and that tells you something maybe about the future. The first question, in terms of display, has to do with the uncertainties of reported assets and liabilities. Do you need more information about details about balance sheet items, such as past accounts receivable, aging of payables, and we could go on from there. Do users have a need for that information and, if so, are you getting that now in any way or not? **[TC 2/2, p. 18]**

Participant C-2
I would say users do have a need for that information and generally will get it. But I think it would be very helpful that some of these things would be readily available as part of financial statements. Particularly some information about the quality of receivables, the agings of payables and receivables. Also the nature of slow moving or obsolete inventory, if that could be disclosed. I think also for businesses that are highly seasonal, if you could give some indication of high/low average receivables, payables, or inventory levels, that would be helpful information. Yes, you do have to get it to do your underwriting. Some of that will already be

available to you. I worry a little bit about companies' willingness to disclose some of these. They consider it to be proprietary. [Also included in 2(d)] **[TC 2/2, p. 18]**

Participant C-4
A lot of times it may be difficult to release records of the company so if the accountants could standardize that information it would be helpful. Also, going back just for a second to the prior question about what additional information for the income statement. If some of the supplementary information that the accountants provide could be standardized, it would help in analyzing cash flows and doing some standard tests of balance sheet items. That type of information, if it's standardized, makes it a lot easier for an analyst to discuss with management and, looking at their internal records, to make comparisons based on year-end audits between companies. [Also included in 5(a)] **[TC 2/2, p. 18]**

Participant C-14
One area that we find has a marvelous predictability when we get it is good information of inventories. It usually tells us a lot about the company's competitive position and whether it's on target with its customers. Unfortunately, because of what's available, we tend to look at the gross level of inventory and see if inventory's rising. That immediately puts up a red flag. And your only option is to go to management, discuss it, and then you're really just listening to whatever they have to say and you have no idea what's happening. If we had an idea of slow moving inventory. If there was a way we could say, inventory over six months or whatever, it would really tell us a lot. And even just finished goods inventory over a certain age would have a tremendous value. **[TC 2/2, p. 19]**

Participant C-5
I just had a company analysis case where we came across a very distorted day's inventory ratio. And it turned out they were doing a ton of spot trading on inventory. And it had only come up in a discussion of some senior people as we were talking about the case and wondering what didn't look right here. This was something in audited financials that I should have had a better sense of. [Also included in 17(a)] **[TC 2/2, p. 19]**

Participant C-7
We're always going back to the customer asking for supplementary information about the agings of receivables and payables, and the inventory break-downs. From our standpoint, that's crucial information. **[TC 2/2, p. 19]**

Participant C-17
Kinds of stuff that would come to my mind is capital expenditure and inventories. What is mandatory or what's repaired, what's unfunded? ... Backlogs or the businesses that are affected by backlogs. What is it? Comparative basis? The inventory, the display, finished, in process, raw, supplies, whatever you may call it, slow moving? Receivables? It drives me nuts when I can't find a provision. Or you can't find what the allowance is, you don't always see a provision. So how do I know what the bad experience is? Borrowing: I hate trying to figure out what maturity horizons are. Fixed assets: categories? Plant? Leasehold improvements? It frustrates me when I look at the liability side and I can't identify trade payables because it's buried in with unrelated payables or accruals. Those kinds of issues come up. I think what most analysts do is they have a group of favorite ratios and they're

pretty standard. And you tend to analyze the company around these but when you can't get to the data. When you can't even identify how to do the calculation, then you're forced to go back to management, and you're not sure, you have no independent verification. [Also included in 13 and 17(a)] **[TC 2/2, p. 19-20]**

Participant C-14
On the liability side, information has become very convoluted and has to do with non-recurring and recurring classification. A lot of companies are classifying commercial papers as internal debt if they plan to roll that paper over. The problem with that is that the information that we can get from current liabilities is an idea of maturities so that we can assess rollover risk itself. The reason to show that as a one-year maturity or less is so that we can assess how much do the capital markets have to keep supplying to this company. The issue is also clouded by swaps, whether the liability is fixed versus variable. **[TC 2/2, p. 20]**

Participant C-17
On the asset side, accountants tend to only allow current assets to the extent that they're going to be intended to be turned into cash. On the liability side, accountants have used a form test that says if this requires repayment under its terms, notwithstanding whether it will be paid, it has to be a current liability. So you don't necessarily have apples and apples. Notwithstanding that, the second question you might raise is that when you account for debts according to their form, then obviously to the extent that you're in that bridge period where you're going for refinancing, things bounce back and forth across the current non-current line. **[TC 2/2, p. 20]**

Committee/Staff/Observer
Is that a problem for users or do they understand the difference between the two sides of the balance sheet? **[TC 2/2, p. 20]**

Participant C-17
I understand what you're saying and I don't have a problem with it as long as it's identified. The clearest example I can think of were contractors undertaking projects. They would always show their taxes under the theory that it might be due the next day. They didn't know exactly when the project was going to be completed. If that was disclosed in a footnote, then at least I knew to go back to the company and to sit down and say, okay, you've got this huge liability on your account on the liability side, that distorts everything. It may not be paid this year you could explore it. **[TC 2/2, p. 21]**

Participant C-4
I think there is a tendency for abuse on the asset side by management. I think what happens is consistently, items are showing up in current assets that are obviously long-term assets if they're assets at all. So I don't know how much work is by accountants to verify the management's intent. [Also included in 17(a)] **[TC 2/2, p. 21]**

Participant C-5
I would go back to [participant C-14] comments about the hedging activities associated with the current liability structure and the way those things are hedged or even the term liability structure with swaps, caps, and collars, and so forth. Tying to, rather than separate,

disclosures about aggregate and totals of these liabilities and off-balance-sheet items will allow you to better understand the variability of the interest charges. [Also included in 19] **[TC 2/2, p. 21]**

Participant C-14
The way I understood what you just said is perhaps you take each of those potential contracts and tie them to the specific instrument that they relate to? [Also included in 19] **[TC 2/2, p. 21]**

Participant C-5
Bundled as opposed to unbundled, that's right. I do realize that certain companies don't ever connect the two instruments together. They hedge in aggregate. And, therefore, you'd never be able to tie it back as an accountant. But in situations where there is a feel that this is a direct link contract, it is beneficial. [Also included in 19] **[TC 2/2, p. 21]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 5—Balance sheet display

a. In general, are you satisfied with the display of information in the balance sheet?

6_ Yes 8_ No

b. If NO in 5a, please indicate your relative preference for the following:

enter
H, M, or L
as in question 4b

____H-3,M-2,L-2 Display separately the assets and liabilities that result from *nonrecurring or unusual transactions or events.*

____H-3,M-3,L-1 Display separately the assets and liabilities that result from *nonoperating activities.*

____H-5,M-3,L-1 Provide *more detail of items* in other assets and other deferred charges and credits, using a materiality threshold that is lower than that currently used in practice.

____H-6,M-3,L-1 Disclose <u>separately</u> *past-due receivables* or an *aging of receivables.*

____H-8,M-2,L-1 Disclose <u>separately</u> *slow-moving inventory* or an *aging of inventory.*

____H-1 Something else. Please describe.

Participant C-17: Disclosure of amounts due to or from officers, employers or related (by control) firms (also disclosed by name) which are not necessarily consolidated.

Participant C-3: Display complete maturity and interest rate of profiles of assets and liabilities.

Participant C-11: The question is awkward - especially items 1 and 2.

[PMQC 2/2, p. 11]

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement. During the discussion, comments were made on display.

Committee/Staff/Observer
Would it be more beneficial to the user community to have information that may make you able to better assess the need for surprise adjustments, say in receivables or inventories? [Also included in 9 and 17(a)] **[TC 3/11, p. 14]**

Participant C-17
Yes. I went back and looked at a spreadsheet that I used to use in 1972, when I started. And it has all kind of little captions that I used to be able to fill out, like aging of receivables. I could go through the receivables and I saw what was actually written off. I can't always do that today. In my mind it's a question of more disclosure and consistency. It's like when you get a fraud, for instance, the apparel manufacturer, [name deleted]; you get those kinds of situations, and they begin to pop up in groups and it shakes people's confidence. You wonder what actually happened. And how did they reach the size that they did? And how did it go on for the amount of time that it did? Some of these frauds are absurd in terms of their lack of sophistication. And yet it wasn't caught. And that's the thing that's most disturbing. You begin to wonder, was the auditor truly independent? Was he caught up in a battle between his peers in terms of staying on the account? I don't know, I'm just saying that it is disturbing. [Also included in 9 and 17(a)] **[TC 3/11, p. 14]**

Committee/Staff/Observer
I'd like to better understand where the focus is in terms of the nature of a company's business and the size of a company. When we talk in terms of aging of receivables, quality of inventory, impairment of assets, what would you expect to see from a [name deleted]-type size corporation versus a smaller company? [Also included in 17(b)] **[TC 3/11, p. 14]**

Participant C-5
I think in the middle market, where you are typically financing the current assets and working capital of the company, the focus is on inventory and receivables. Take a [name deleted], though, and I don't want to know what the carrying value of its plants and facilities is. I have to have a sense of levels of utilization of those plants and facilities. An auditor should realize that a user of the financial information would have certain critical concerns about this company

and should be able to provide detail on these that would allow us to make our own assessment. I really want to know your assumptions so that I can say: "I discount those assumptions," or "I accept your assumptions," or "I'm more optimistic." That's where I might make the lending decision and someone else wouldn't. Otherwise we're all making the exact same decision because we've used one opinion on the numbers. But, in the large corporates it's more looking at the expense structure; the fixed variable, the employee component, the discontinuing operations, segment reporting, and the ability to understand business exits that might occur, and which ones would be most probable for the company. [Also included in 17(b) and 17(c)] **[TC 3/11, p. 14-15]**

Committee/Staff/Observer
And it would be safe for me to leave today with an understanding that maybe your needs with respect to middle market smaller organizations might be different than they would be in a Fortune 500? For the former focus is on perhaps the quality of the underlying assets and perhaps with the latter it's the quality of the underlying control systems and environments, and those kinds of things; is that a fair thing for me to walk away with? [Also included in 1(b) and 17(b)] **[TC 3/11, p. 15]**

Participant C-1
I don't know if I agree with that at all. Some of the companies that we lent to, that are high-yield companies, are in the Fortune 500. And I think what we're concerned about is the quality of the inventory and the quality of the receivables. If we're lending to a company that the inventory is good for all time to come, fine, but I can't tell you the number of times we've lent money to a company and all of a sudden 20% of their inventory, while it's still good and could be sold, might take ten years to sell it, because no one wants it. And it's been sitting there forever and it's not a current asset, it's really a long term asset. Or, with [name deleted], how many parts do they have that go for a 1980 model that are still sitting in inventory, that really are not going to be liquidated, or not going to be used for the next year; it really is a long-term asset? That's where I become more concerned. You know we're all concerned about environmental problems, and pension problems, and legal liabilities, but the concept that inventory is always a current asset, as we're all trained and taught in business school and undergraduate, just isn't true anymore. [Also included in 1(b) and 17(b)] **[TC 3/11, p. 15]**

Participant C-15
But companies do separate inventories into current and long term assets. I would argue that if [name deleted] is still holding parts for 1980 cars, it should be considered a long-term asset. It should be written off. **[TC 3/11, p. 16]**

Participant C-1
I can honestly tell you, I don't know of any company I've ever seen like that, at least in my area. **[TC 3/11, p. 16]**

Participant C-11
I don't think you can define beforehand middle-size companies versus large in terms of what the critical data is and that an audit might have to have. Also, I am all in favor of disclosure

and we've certainly talked in the past in these rooms about aging of receivables and things like that. But I don't think that should excuse the auditor from having to think about those subjects if they happen to be put into some disclosure format. I think the auditor is responsible and has to consider the reasonableness aspects of those numbers and in terms of, if they are putting out a clean opinion on these companies, which we are relying on, whether they should have caused things to be reassessed or written down. I think that's an auditor responsibility that has kind of been glossed over and perhaps forgotten. But I think it's there if you're going to put out a clean opinion. [Also included in 17(a) and 17(b)] **[TC 3/11, p. 17]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of conservatism, volatility, reliability, and neutrality. During the discussion, comments were made on display.

Participant C-1
I'd rather have assets that you anticipate in some way liquidated over a short period of time, one year, to be extremely conservative. And I don't mean being hidden but I think that there are assets which are not truly short term assets that are put in that section. [Also included in 2(b)] **[TC 3/11, p. 41-42]**

Participant C-1
Just in terms of the inventory, I would just take out of current assets anything that the banks wouldn't lend against. Because then it's not current. [Also included in 2(b)] **[TC 3/11, p. 43]**

Participant C-17
But that's not always the case. If I'm sitting as a secured lender to the inventory, I'm looking at it in terms of what's it going to bring to me if it liquidates. So a lot of times, a lender's going to advance against his perception of liquidation value, not the normal operating cycle. [Also included in 2(b)] **[TC 3/11, p. 43]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting. During the discussion, comment were made on display.

Participant C-14
9, 11 and 13. And no particular order. Starting with number 9, display of financial information. We at one time talked about more focus in the balance sheet on liquidity going from maybe differentiating current liabilities rather than just something that matures under one year but get into how much of it is truly interest rate sensitive and how much is reflex roll over or refinancing risk. So I'd want to stress that. And also stress the things we talked about in the cash flow statement. We talked about going to a direct cash flow statement and I'm still in favor of that. 11, core earnings. I think everybody's said enough about that covers my views.

13 (financial instruments); it is very important to find a new way to assess the company's cash flow sensitivity to all those items related to financial off-balance-sheet transactions that are difficult for us to understand as they're presented today. [Also included in 5(c), 15, and 19] **[TC 3/11, p. 69-70]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 11--Balance sheet display

a. In general, are you satisfied with the display of information in the balance sheet?

Yes *2* No *5*

b. If you checked "no" in 11a, please indicate your relative preference for the following items by marking H, M or L in each space (if you checked "yes" in 11a, please jump to question 12).

:

rank
H, M, or L
as in question 10b

	High potential	Moderate potential	Low or no potential
Display separately the assets and liabilities that result from nonrecurring or unusual transactions or events.	*3*	*1*	*1*
Display separately the assets and liabilities that result from nonoperating activities.	*2*	*3*	
Provide more detail of items in other assets and other deferred charges and credits, using a materiality threshold that is lower than that currently used in practice.	*4*	*1*	
Display separately past-due receivables or an aging of receivables. *Participant I-9*: This is crucial.	*6*		
Display separately slow-moving inventory or an aging of inventory.	*5*	*1*	
Something else. Please describe. *Participant I-9*: The same kind of information in a D&B report for a slow paying company. *Participant I-12*: Any and all financial operations should show an average balance sheet with average rates paid and earned.	*1*		

[PMQI 12/9 and 1/13, p. 19-20]

Analysts were able to identify many areas in which they believed expend disclosures would be useful, but most of those had little or no relation to fair value information. The disclosures they were most interested in were: [Also included in 3(c), 3(e), 10(c), 5(a), 13, and 17(f)] **[KPMG BANK STUDY, p. 38]**

- Disclosure of problem loans and other impaired assets, including internal loan classification, original principal amount, interest rate, geographic location, industry, nature of problem, and other pertinent loan-specific information [Also included in 13] **[KPMG BANK STUDY, p. 38]**

- Expanded disclosures of the allowance for loan losses [Also included in 10(c)] **[KPMG BANK STUDY, p. 39]**

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(b), 2(c), 4, 5(a), 5(c), 5(d), and 13] **[KPMG BANK STUDY, p. 39]**

- Preferred historical cost financial statements supplemented with fair value disclosures [Also included in 4, 5(a), and 5(c)] **[KPMG BANK STUDY, p. 39]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

[One analyst] would like more data on off balance sheet items and admits that she eliminates goodwill from the balance sheet. She does admit, however, that other intangibles may have some value. [Also included in 1(b), 7(a), and 7(b)] **[GOLDMAN, p. 2]**

5(c). Cash Flow Statement

Need for the Direct Method of Presenting Operating Cash Flows [following 3 paragraphs]: We need a cash flow statement that is consistent in format and *can be used for comparison with related line items on both the income statement and/or a cash flow projection.* It is not enough to know why net income is different from net cash from operations. We also must know why revenues are different from the cash collected and why payments for goods are different from the cost of goods sold. For example, consider the broadcasting industry where barter arrangements are common. They result in noncash sales and noncash expenses. There is no adjustment necessary to produce agreement between income and cash flow from operations, but there may be significant adjustments to the gross amounts included therein. **[RMA92, p. 3]**

In addition, we use historic cash flow data to estimate our customers' future borrowing needs and repayment capacity. That involves projecting actual cash flows, collections and payments, not reconciliations between net income and net cash flow. The indirect format is almost useless for such purposes. **[RMA92, p. 3]**

We hope we have been successful in communicating to you the reasons that explain the strong desire of credit analysts for cash flows from operating activities to be presented in the direct format. Furthermore, we note that *FAS 95 encourages* use of the direct method (paragraph 27), although it *permits* use of the indirect method (paragraph 28). Therefore, we feel that the Special Committee should make equally detailed inquiries of financial statement preparers and their accountants as to the specific reason(s) for their unwillingness to provide cash flows data in a format that is advocated by the FASB as well as by RMA and a variety of other financial statement users. As a matter of fact, we would be interested in knowing whether *any* users interviewed by the Special Committee expressed a preference for the indirect method and, if so, why. **[RMA92, p. 3]**

Need for a One-Year Cash Flow Forecast [following 4 paragraphs]: Many of your questions regarding this subject can be answered with a simple statement. We make loans to enterprises that currently do not have sufficient cash to make business investments that are intended to generate more than sufficient cash in the future to repay the loan. It is our job, in making the loan, to assess the amounts, timing and uncertainties of those future cash flows. What document could be more relevant to and useful for that purpose than the enterprise's own projections of its cash flows, prepared under the supervision and with the advice of its independent accountants? [Also included in 12] **[RMA92, p. 3]**

To be more specific, we use the projected cash flow data to: (1) assess the viability of the operation, (2) project debt service capability, (3) anticipate additional borrowing needs, and (4) understand the borrowers' expectations. We do not use those projections without first testing them for reasonableness. That task that is diminished in importance and complexity when either or both of two factors are present. One is the involvement in the forecast of the borrower's independent accountant. The other is assumptions that are set forth in detail; the more detailed they are, the less reasonableness testing we have to do. Nevertheless, we as lenders tend to "haircut" the borrowers' expectations and to supplement them with our own worst case scenarios. But, we do use forecasts! [Also included in 12] **[RMA92, p. 4]**

You also ask why cash forecasts would be useful if there were more detailed income statement data and cash flows were presented in the direct format. The point is forecasts address the *future*. No amount of additional detailed reporting about the past, either on the income statement or on the cash flow statement, can replace projections of the future. Did we misunderstand you here? [Also included in 12] **[RMA92, p. 4]**

Finally, you should never ask a user how much detail is necessary. We are sure you already have heard from others that there is no end to user requests for detail. To be practical, however, an income statement, cash flow statement (direct method), and a cash flow forecast should all have the same level of detail. Our work is to compare them. If we could know why past revenues and expenses are different from past cash receipts and collections and why each of those is different from expected future receipts and collections, the quality of our analysis and lending activities would be aided immeasurably. **[RMA92, p. 4]**

The APC [Accounting Policy Committee] believes that a complete set of financial statements must contain a statement of cash flows. The purpose of that statement is to inform financial statement readers of the behavior of enterprise cash cycles which can differ vastly in timing from operating and investment cycles. The cash flow statement should display gross changes in cash and cash equivalents, and they should be classified by operating activities, investing activities and financing activities. The APC believes that the direct method of displaying operating activity data provides information that is most useful in judging a company's liquidity, financial flexibility, and financial risk. Gross cash flows are superior to net flows as an indicator of a company's maximum borrowing needs and the source and availability of cash inflows for debt servicing. [Footnote reference omitted] **[RMA90, p. 4]**

Lenders also require information about significant investing and financing transactions that do not produce cash flows, but those data should be presented only in schedules that are clearly designated as supplementary to the cash flow statement. **[RMA90, p. 4]**

The balance sheet receives far less attention than the income statement [by equity sell-side analysts], and the occurrences of balance sheet type words and phrases occur far less frequently [in analysts' reports]. Much of the attention to balance sheet items comes in the form of liquidity and cash flow analysis. For example, reports may assert balance sheet strength on the basis of a company's free cash flow. While several income statements are almost always presented, many reports contain only summary balance sheets. [Also included in 1(b), 1(c) and 5(b)] **[PREVITS, p. 17]**

[A]nalysts asserted that a cable television company had substantial off-balance-sheet assets in the form of residual payments to be received in the future. They calculated the value of the company using several methods, one being the present value of the anticipated cash flows from these residuals. One analyst stated that "balance sheet recognition of . . . hidden asset values . . . will occur in future years". Other examples include inventory and reserve valuations of extractive industry companies. For instance, in gold mining companies, a market value

appraisal is included of the reserve values by ore type. [Also included in 1(b), 1(c), 4, and 5(b)] **[PREVITS, p. 17]**

Liabilities are usually addressed in a summary fashion, often in a simple analysis of the capitalization of the corporation. Extensive attention to liabilities usually only occurs for companies that are highly leveraged and typically in conjunction with a cash flows analysis. [Also included in 1(b), 1(c), and 5(b)] **[PREVITS, p. 17]**

Cash flow analysis [by equity sell-side] analysts displays considerable variety in format and content. Many reports present and/or discuss cash flow extensively. Cash flow information is sometimes presented by segment or operating unit. Some reports make no mention of cash flow at all. Cash flow type phrases occurred about 6,000 times in the full sample. [Separately, dividends are mentioned over 2,000 times.] [Also included in 1(b), 1(c), and 3(c)] **[PREVITS, p. 18]**

Although cash flow per share calculations are not permitted in audited filings under SEC rules nor by SFAS 95, cash flow per share and operating cash flow per share are almost always calculated by analysts when they provide any cash flow data. Analysts also calculate "fully diluted cash flow per share" and some provide "distributable cash flow per share", "excess cash flow per share", "discretionary cash flow per share", and "free cash flow per share." [Also included in 1(b) and 1(c)] **[PREVITS, p. 18]**

Some [equity sell-side] analysts compute a price to cash flow ratio, and present a comparison of this ratio with other companies in that industry. Others assess the relationship between cash flows and earnings. For example one report stated that the value of a company was "compelling" because "operating cash flows are 4.3 times 1990 earnings". Another analysts encouraged purchase of a major tobacco company's stock because of its "tremendous surplus cash flows". [Also included in 1(b) and 1(c)] **[PREVITS, p. 18]**

Cash flows seem to be more important to [equity sell-side] analysts in evaluating smaller companies, and less so in evaluating larger companies, with the exception of highly leveraged larger companies or ones in which a dividend cut is possible. One report, for example, states that "The important figure . . . for evaluation of smaller petroleum . . . companies is operating cash flow per share." Another stated that in comparison with cash flow "historical financial results of [the company] are irrelevant". [Also included in 1(b) and 1(c)] **[PREVITS, p. 18]**

Examples of unorthodox cash flow formats [presented by equity sell-side] analysts in addition to free cash flow and discretionary cash flow arrangements are: [Also included in 1(b) and 1(c)] **[PREVITS, p. 18]**

Net income
  +/- all effects except cash interest
  = cash flow available to common
  - cash interest
  = net cash flow
Direct operating cash flows
  - priority outflows
  - discretionary outflows

+ financial inflows
= change in cash
[Also included in 1(b) and 1(c)] **[PREVITS, p. 18]**

It was also intriguing to discover an example where the "foreign exchange cash flow" in a statement of cash flows was presented outside the three traditional categories of the SFAS 95 format. [Also included in 1(b) and 1(c)] **[PREVITS, p. 18]**

[Context] The following brief summary of the topic "Income and Cash Flow Statements," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Throughout the report, there are repeated recommendations that the FASB needs to develop its concept of "comprehensive income." Much of this section of the report is devoted to integrating those references and explaining in much greater detail all the reasons why that development is needed and how it should proceed. [Also included in 5(a)] **[AIMR/FAPC92, p. ix]**

The other part of this section deals with the cash flow statement. Most financial analysts were pleased with the issuance of *FAS 95*, which requires that a cash flow statement replace the less useful statement of changes in financial position. They are not pleased with the quality of information contained in many of the cash flow statements they currently receive. First, virtually no companies have chosen to present cash flows from operations on the direct method. Failure to do so has been accompanied by arguments that are unconvincing because they are contradictory. Second, because so many cash flow statements contain detectable errors, we call for establishment of an authoritative literature on cash flow statement preparation. [Also included in 5(a)] **[AIMR/FAPC92, p. ix]**

[Context] It indicates the scope of the discussion of the topic and lists the report's major recommendations, providing an introduction to the following excerpts from the report.

Over the span of the FASB's existence, its pronouncements have become more and more oriented to the statement of financial position. This is meant as an observation, not criticism. [Also included in 5(a) and 5(b)] **[AIMR/FAPC92, p. 41]**

Perhaps the most apt example is FAS 109, "Accounting for Income Taxes." It fixes its attention on identifying at a point in time those transactions and events that are deemed to have future tax consequences, then measuring the effect on financial position of the benefit(s) and/or obligation(s) resulting from them. Their effect on periodic income is calculated only as the necessary consequence of those financial position assessments. This is an approach opposite from the now-superseded Accounting Principles Board Opinion 11 in which the objective was to measure the deferred portion of the current period's provision for income taxes, with

resultant balance sheet residuals called deferred tax liabilities and/or assets. [Also included in 5(a) and 5(b)] **[AIMR/FAPC92, p. 41]**

We applaud the efforts and accomplishments of the FASB in making balance sheet amounts more meaningful than before. Prior to FAS 109 (and its short-lived predecessor, FAS 96), deferred tax accounts on the balance sheet had little meaning since they were remnants of past income statements, whereas today they depict amounts that the enterprise expects to result in future cash flows. However, as FAS 109 and various other standards have been promulgated we feel that the development of the income statement has been neglected. We also feel as if more could be done to make cash flow statements more accurate and more useful to analysts. The purpose of this short section is to summarize our views on those matters: (a) with respect to the income statement, primarily to summarize information scattered throughout earlier parts of this report; (b) with respect to cash flow statements to introduce new material. [Also included in 5(a) and 5(b)] **[AIMR/FAPC92, p. 42]**

The Statement of Cash Flows

Financial analysts have mixed feelings about FAS 95, "Statement of Cash Flows." We are gratified that it was issued because it mandates that a cash flow statement be issued and codifies the form and content of the statement. That brought to a welcome demise the old statement of changes in financial position and it eliminated many of the variations in practice among companies that did publish cash flow statements. **[AIMR/FAPC92, p. 44]**

Since the issuance of FAS 95, the cash flow statements that have appeared in published financial reports have been much less useful in analysis than we might have expected. First, almost no public company presents its cash flows from operations using the direct format; virtually all use the indirect format. We have learned since the issuance of FAS 95 that it is extremely difficult or impossible in most cases to calculate reasonable estimates of gross operating cash flows (direct-method) using only the data provided in financial reports using the indirect method.[14] A second deficiency is the imprecision with which FAS 95 appears to be applied. There is need of an authoritative literature to resolve a variety of ambiguous situations as well as to forestall the many detectable errors we have encountered in published cash flow statements since FAS 95 was issued. We can only speculate on the number of undetectable errors that must also occur. **[AIMR/FAPC92, p. 44]**

The Direct Method of Reporting Cash Flow From Operations

FAS 95 states, in paragraph 27:

> *In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum--the net cash flow from operating activities (the direct method).* **[AIMR/FAPC92, p. 44]**

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[14] For the reason, we have made clear our position that the direct method must be followed in our more recent comments to the International Accounting Standards Committee in letters dated July 25, 1990 re. *Statement of Principles--Cash Flow Statements*, and January 20, 1992 re. *E36--Proposed Statement of International Accounting Standards, Cash Flow Statements.*

E36, Exposure Draft 36 of the International Accounting Standards Committee, Proposed Statement, "Cash Flow Statements" states, in paragraph 23: **[AIMR/FAPC92, p. 45]**

> *Enterprises are encouraged to report cash flows from operating activities using the direct method.* **[AIMR/FAPC92, p. 45]**

Both standards-setting bodies cite the direct method as the preferred method of presenting cash flows from operations. Investment professionals represented by AIMR have expressed their desire for the direct method. We have observed that the Robert Morris Associates, representing over 15,000 bank loan and credit officers in the United States, has adamantly advocated the direct method.[15] Despite the overwhelming expressions of support for the direct method by virtually all professional users of financial statements, it is the indirect method that appears almost without exception in published financial reports. **[AIMR/FAPC92, p. 45]**

Two contradictory reasons are given to support the indirect method over the direct. First, it is asserted by some that the specific items used in the indirect method to reconcile income to net cash flow from operations can easily be evaluated by an analyst as to the individual revenues and expenses to which they apply. It is said that the revenues can then be adjusted to determine gross cash collected, the expenses to compute gross cash outflows. Second, it is asserted by many reporting firms that they do not keep their records in such a way as to permit reporting operating cash flows in gross amounts, thereby making the direct method prohibitively expensive to implement. **[AIMR/FAPC92, p. 45]**

With respect to the first argument, as a practical matter, there seldom is sufficient detail given in published financial statements of the individual reconciling items to make the adjustments suggested. More often than not, a multitude of individual items appear in the operating section of the cash flow statement as a single number described as "Other," "Other assets and liabilities--net," "Other noncash credits," "Other, net," "Other adjustments--net," etc. In many cases, the level of detail presented in the enterprise's income statement is inconsistent with that in the cash flow statement and it is consequently impossible to make all of the necessary adjustments. Finally, if the reconciling items "can easily be evaluated by an analyst," they can even more easily (and accurately) be evaluated by the reporting enterprise. Not only that, but evaluation and adjustment, if done by the reporting enterprise, need be done only once, thus saving the greater efforts and lesser accomplishments of the scores of individual analysts who may follow that firm. **[AIMR/FAPC92, p. 45]**

The second argument, professing the high cost of preparing direct format cash flow statements, also is unpersuasive. First, it directly contradicts the first argument, that conversion from direct to indirect is easy, even by analysts relying only on publicly-available data. Second, one must inquire as to who bears the costs of preparing financial statements. The costs are paid out of general corporate funds and, ultimately, are borne by the firm's investors, that is the users of financial statements. If financial statement users demand information in a particular form, then it should be provided. If the costs of providing such information truly

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[15] RMA's position is set forth in public letters to the FASB dated April 21, 1986, September 27, 1986, February 17, 1987, July 14, 1987, and January 5, 1989.

are prohibitive, the demand will cease as investors refuse to absorb the concomitant decrease in the value of their holdings. **[AIMR/FAPC92, p. 45-46]**

A reasonable solution to this apparent impasse is not unattainable. Although neither the FASB has seen fit to mandate the direct method nor is it likely that the IASC will, both endorse it as the preferable method. Nothing other than inertia prevents progressive firms that seek favor with analysts from adopting the direct method. We reiterate, not only is the direct method permitted, it is preferred! As professional associations representing financial statement preparers and their auditors consider how they may better provide information that is valuable to financial statement readers, they should take it upon themselves to champion the direct method of reporting cash flow from operating activities. **[AIMR/FAPC92, p. 46]**

Need for an Authoritative Literature on Cash Flow

The need for such a body of authoritative literature manifests itself in two ways. First, there are a variety of accounting matters where the correct treatment on a cash flow statement is not readily apparent. Inasmuch as cash flow is factual, totally exchange-based and devoid of allocations, these are entirely questions of classification. Some examples are: **[AIMR/FAPC92, p. 46]**

- APBO 30 specifies that the income statement shall present discontinued operations separately from continuing operations and sets up appropriate definitions and procedures.[16] It is unclear from FAS 95 as to whether cash flows from operating activities should similarly be classified into two distinct components. If the response is affirmative, to what extent and how should taxes paid be allocated between the components of operating activity on the cash flow statement, a question similar to that of intraperiod tax allocation on the income statement. **[AIMR/FAPC92, p. 46]**

- FAS 94 requires the consolidation of all majority-owned companies. Many of these are finance and insurance subsidiaries. Some are integral parts of the parent enterprise's operating activities, others finance and insure primarily unrelated customers, whereas others are a blend. To what extent, and following what criteria, are the cash flows related to their receivables and payables to be treated as part of operating activities, as opposed to investing and financing? **[AIMR/FAPC92, p. 46]**

- Certain enterprises manufacture product that may either be sold or be converted to use as plant assets of the enterprise itself. Examples include certain real estate developments and computers that may be either rented (on operating leases) or sold. How is the cash spent to produce these items to be classified (operating or investing?) when the enterprise itself does not know their final disposition until after they have been produced? **[AIMR/FAPC92, p. 46]**

There are many other similar questions of classification, but we wish only to illustrate the nature of our concerns. **[AIMR/FAPC92, p. 47]**

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[16] Recent research has suggested that these definitions and procedures are insufficient to prevent biased applications of them. See Donna Rapaccioli and Allen Schiff, "Reporting Sales of Segments Under APB *Opinion No. 30*", *Accounting Horizons*, December 1991, pages 53-9.

The second need for authoritative literature is as a bulwark against the myriad errors we have seen in published cash flow statements. We can only speculate as to whether they are the result of ignorance, thoughtlessness or carelessness. The following examples are illustrative.[17] **[AIMR/FAPC92, p. 47]**

- One firm showed as a cash outflow from financing activities the total amount of $30,197 of dividends declared. The $325 increase in its dividends payable account was added to net income in the computation of cash flow from operations. **[AIMR/FAPC92, p. 47]**

- Another corporation included among its investing cash outflows for capital expenditures, and among its financing cash inflows from long-term borrowing, the amounts of assets and liabilities recorded at the inception of capital leases during the year. **[AIMR/FAPC92, p. 47]**

- Several companies show bank overdrafts as current liabilities on their balance sheets. These companies then place the amount of the change in that liability on the cash flow statement as an adjustment of income in the calculation of cash flow from operations. That treatment is tantamount to making the cash flow statement directly contradictory to the balance sheet. The balance sheet asserts that payments have been made by overdrawing a bank account; the cash flow statement asserts that the payments were not made. One of those statements has to be false and misleading. **[AIMR/FAPC92, p. 47]**

- A firm states in the notes to its financial statements that it "acquired 168 businesses, all of them accounted for as purchases, for $303,601,000 in cash and notes." The cash flow statement shows a cash payment of $303,601,000. The amount paid for with notes should not have been reported on the cash flow statement; it should have appeared as supplementary data. **[AIMR/FAPC92, p. 47]**

- That same firm shows an increase in its "Investment in a less-than-majority-owned affiliate" from a beginning balance of $-0- to an ending balance of $249,718. The firm's cash flow statement shows a deduction from net income for $5,017 of equity earnings from the investment; yet the supplementary data state that the cost of the investment in the affiliate (none paid in cash) was $249,718. **[AIMR/FAPC92, p. 47]**

- A third violation by that same firm is its deduction from income in computing cash flow from operations of an after-tax gain of $11,354 recognized from certain nonmonetary transactions, even though the gain was properly reported on the income statement in its pre-tax amount. **[AIMR/FAPC92, p. 47]**

The solution to the sorts of problems listed above has two facets. First is the need for detailed procedural guidance to the preparation of cash flow statements well beyond that incorporated in intermediate accounting textbooks. Second, both the preparers and auditors of financial

[17] Because errors of the type we cite are so frequently encountered in published cash flow statements, we see no point in naming and possibly embarrassing the individual companies responsible for the examples cited below.

statements need to educate their personnel. We deliberately use the word "education," not "training." We believe that instruction in procedural matters is secondary to an understanding of the role of the statement of cash flows as a major financial statement and the philosophy of its system of classification into operations, investing, and financing. We suspect that in practice it frequently is prepared in haste as a derivative of the audited balance sheets and income statement without due consideration for its unique and eminent position among the major financial statements. **[AIMR/FAPC92, p. 48]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. The first part of the meeting was devoted to the topic of disaggregated information. During the discussion, comments were made on cash flow statements.

Committee/Staff/Observer
How about the third bullet? If consolidating financial statements are required, should they include consolidating cash flow statements? And should the direct or indirect method be required or should the format be optional? [Also included in 3(e)] **[TI 12/9, p. 26]**

Participant I-6
Yes, they should be required. I think the cash flow statement is extremely important. [Also included in 3(e)] **[TI 12/9, p. 26]**

Committee/Staff/Observer
We don't seem to have a strong feeling one way or the other on the direct versus indirect method question. [Also included in 3(e)] **[TI 12/9, p. 26]**

Committee/Staff/Observer
I'm surprised there's not more reaction for a change to the direct method of cash flow reporting because I have heard that before. [Also included in 3(e)] **[TI 12/9, p. 26]**

Participant I-12
I'm still waiting for someone to come up with a decent definition of cash flow in a financial company. [Also included in 3(e)] **[TI 12/9, p. 26]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
How disruptive would it be if you didn't have a balance sheet? [Also included in 5(b) and 11(c)] **[TI 1/13, p. 36]**

Participant I-8
Very. I can remember when quarterly balance sheets were a rarity. An income statement is worthless without a balance sheet. I would also love to see a quarterly cash flow statement. [Also included in 5(b) and 11(c)] **[TI 1/13, p. 36]**

Committee/Staff/Observer
Let's move to cash flow statement display, which is our last question in the general area of display. Under current rules, amounts on the cash flow statements are classified in one of three categories: operating, investing, or financing. Operating activities is the catch-all category. In other words, amounts in the operating activities category include all cash flows except those that can be specifically identified as belonging in investing or financing activities. Companies can report cash flows from operating activities under either the direct or indirect method. Although the rules encourage companies to follow the direct method, the vast majority of companies follow the indirect method. **[TI 1/13, p. 37]**

The meeting materials identified two areas in which better display might assist you. First, perhaps it could assist you in the identification of unusual or nonrecurring cash flows. Second, better display on the cash flow statement might improve your insight into the company's business. The meeting materials provided some ideas in each of those categories. We are interested in your reactions to those ideas, and other ideas that you have about display on the cash flow statement. **[TI 1/13, p. 37]**

Participant I-11
There is some appeal to getting the distinctions you get from the direct method, but to talk about cash received from customers and cash paid to suppliers and employees is worthless. I don't care about that; I do care about what's happening with receivables, with inventory, with depreciation. So I understand why the companies are opting for the indirect method. **[TI 1/13, p. 37-38]**

Committee/Staff/Observer
Does it help you if you tie the cash flow statement and the information you get from the direct method together with the comments made earlier about income statement display? Comments about the cash and noncash charges and the nature of expenses, for example. **[TI 1/13, p. 38]**

Participant I-11
Some of the information about the direct method, other than cash paid to suppliers and employees and cash received from customers, is useful information to have, but that's less useful to me than understanding more clearly where that cash is going. **[TI 1/13, p. 38]**

Participant I-8
I prefer the indirect method. **[TI 1/13, p. 38]**

Participant I-15
I prefer the indirect method also. **[TI 1/13, p. 38]**

Committee/Staff/Observer
What if we had the operating section of the cash flow statement look just like the P&L does? Would that be useful? **[TI 1/13, p. 38]**

Participant I-5
That's fine. **[TI 1/13, p. 38]**

Participant I-11
It might but I don't know; I've never seen one. **[TI 1/13, p. 39]**

Participant I-12
I haven't seen a meaningful cash flow statement for a financial company yet. We're starting to see much more transactions that have accretions. So you have phantom income these days, as well as amortization, and that needs to be highlighted. We would like to know what that is. **[TI 1/13, p. 39]**

Committee/Staff/Observer
I have two questions in the area of cash flows. One, I'm wondering if you make adjustments in an attempt to arrive at free cash flows? And if you do, how do you define free cash flows and would you find a common definition of free cash flows helpful to you? **[TI 1/13, p. 39]**

Participant I-8
You have to start with an estimate of earnings and capital expenditures. Your estimate of earnings has an assumption of revenue. So, how much working capital, based on historic ratios, do I need and how much dividends will I pay? Everything else is free cash. Then, you have to say whether you want core free cash flow or something else. **[TI 1/13, p. 39]**

Participant I-12
It's reminiscent of the LDC loan loss reserve where [name deleted] set aside billion of dollars, and it looks like something like a third of that is going to have to come back into the income statement at some point. It's a similar issue. **[TI 1/13, p. 40]**

Committee/Staff/Observer
The second question is: would you find cash flow per share useful? **[TI 1/13, p. 40]**

Participant I-14
Where would you put this? I would find putting it in the front page very dangerous, because we're not the only people who read annual reports and unless you want to say it's only for people over 21 . . . That's just a dangerous number to have floating around. **[TI 1/13, p. 40]**

Participant I-8
For example, for a leasing company, if you only put gross cash flows and not consider capital expenditure, you are going to get terrible distortions. It's dangerous if somebody tries to use that number without understanding the implications of the different businesses. **[TI 1/13, p. 40]**

Committee/Staff/Observer
Would you prohibit it, as is currently prohibited, or would you allow companies to disclose it? I'm thinking of a company that has a lot of acquisitions and amortization of intangibles is a big number. **[TI 1/13, p. 40]**

Participant I-8
We had a lot of that discussion when we talked about acquisitions and how you account for them. What came out was we will make that adjustment; it's easy. **[TI 1/13, p. 40]**

Committee/Staff/Observer
And you take it one step further and compute a per share basis? **[TI 1/13, p. 40]**

Participant I-8
We do. **[TI 1/13, p. 40]**

Participant I-5
I would like to get quarterly cash flow statements in 10-Qs, just for the three month period. [Also included in 11(b)] **[TI 1/13, p. 41]**

Participant I-7
Every company should be required to issue 4 quarters of information, the final quarter specifically. [Also included in 11(b)] **[TI 1/13, p. 41]**

Participant I-11
And the quarter should include the quarterly cash flow. [Also included in 11(b)] **[TI 1/13, p. 41]**

Participant I-12
And we need to have a reconciliation between the annual report and the four quarters. [Also included in 11(b)] **[TI 1/13, p. 41]**

Participant I-5
I feel passionately about providing quarterly information including the fourth quarter and each quarter's cash flow statement. [Also included in 11(b)] **[TI 1/13, p. 42]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting. During the discussion, comments were made on interim cash flow statements.

Participant I-12
The big difference between the two is cash versus accrual accounting. If we had quarterly cash flow statements, a lot of these factors would be captured; for example, the compensation example, the advertising example, the repair example. We would know that the particular event happened in a specific quarter but we would also have statements that would allow us to

do the trend line analysis that is essential to our work. [Also included in 11(c) and 11(d)] **[TI 3/17, p. 45]**

Participant I-12
Like [participant I-11], I would tend to lean toward the integral approach [of interim reporting] if I could get quarterly cash flow statements. [Also included in 11(c) and 11(d)] **[TI 3/17, p. 47]**

Participant I-5
I would be leaning toward the integral approach with greater disclosure, particularly if you can build the disclosure through the cash flow statement. But if you take away the cash flow statement, then I switch and go with the discrete method. [Also included in 11(c) and 11(d)] **[TI 3/17, p. 47]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on display.

Participant C-2
I would like to see direct method cash flow presentation, for cash from operations. The gross cash flows are very important to us, and the indirect method does not let you get at those with any source of comfort. You can back into them mathematically and assume that the number you get mathematically is equivalent to cash flows, but I think a direct method cash flow would be a big improvement for presentations. I would put that first as my first priority. I think we can get at disaggregated information a lot of times in our dealings with our borrowers, but getting the direct method cash flow as part of an audit or reviewed statement is important. [Also included in 15] **[TC 12/8, p. 27]**

Participant C-5
I think the direct method of cash flow reporting is something that I think is overdue. We end up reconverting everything that we receive on a cash flow format. So that's just a simple one of format and readability and understandability that I think would go a long way. I don't know how to emphasize that enough. [Also included in 1(b)] **[TC 12/8, p. 40]**

Committee/Staff/Observer
I'd like to follow up on that. When we've had FASB 95 out for five years, most users and most preparers and auditors use the indirect method. I've tried to challenge in my own practice why I should go the direct method, and I'd love to understand what the information content is there that you're looking for? [Also included in 1(b)] **[TC 12/8, p. 40]**

Participant C-5
For me, I'm a financial analyst as well as an accountant, and I think the source of the information is more fitted to the indirect method, but the use of the information is fitted to the direct method. [Also included in 1(b)] **[TC 12/8, p. 41]**

Participant C-1
The only comment I have on direct versus indirect cash flows is that I've had one company report both. It's very nice to have direct cash flow. The problem is that you can never jibe the two, it never worked, and there was always a different number for direct versus indirect, and they were never consistent. [Also included in 1(b)] **[TC 12/8, p. 42]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
There are two questions here about the detail included in a cash flow statement. And the format of that cash flow statement. Is the format question an important question? What does the current indirect format, which is acknowledged to be the one that is highly used, failed to do for you the direct format would solve? And would you want the cash flow information in the same level of detail as the income statement, including identifying non recurring and unusual items separately? **[TC 2/2, p. 21-22]**

Participant C-5
I am a strong proponent of getting cash flow information in a different format than we currently get it. I didn't hear anybody suggest at the last meeting a full cash income statement. But it sounds like a nice proposal. I need more and a better format for cash flow; in a comparable income statement format on a cash basis would be probably the only way to do it. Then the question is again, cost. And I've got to be fair to the borrowers who I've worked with that "am I demanding too much?" and "is there a cheaper way to get it?" I wouldn't expect it to be a high cost approach to the problem. It clearly would be a satisfactory approach. We still are going to end up converting statements prepared under the indirect method to the direct method. We start with the EBIT line and work our way down to a OCF type of number (operating cash flow) which is prior to working capital changes, then a supplemental analysis of the effects of working capital changes on cash flow ultimately coming to a cash from operations. And then working into our understanding of the demands on cash flow, that being interest and fixed charges, what we consider investing, financing activities. Where we end up with cash flow, I think we understand it well, but it's just we have to do a lot of work. [Also included in 2(d)] **[TC 2/2, p. 22]**

Committee/Staff/Observer
[Participant C-13] are you at a disadvantage vis-a-vis [participant C-15] in terms of what you have in front of you to work with? Do you go ahead then and do reformatting? **[TC 2/2, p. 22]**

Participant C-13
We try. It's frequently not possible based on current disclosures. **[TC 2/2, p. 22]**

Committee/Staff/Observer
When you're reformatting or are you reformatting working toward the EBIT line? Or were you trying to reformat first to get to a direct kind of format? **[TC 2/2, p. 22]**

Participant C-13
To get to a direct kind of format. We then try and do the operating cash flow that [participant C-5] talked about. That's what we're trying to establish. **[TC 2/2, p. 22]**

Participant C-14
Under the indirect method, we use the investing and financing activities segments because they're pretty well laid, but cash flow from operations is not adequate. We never see the direct method among the companies that we rate. For the purpose of analysis, the cash income statement [participant C-5] mentioned would be the most useful. Short of that, we would be as [participant C-13] says making adjustments to the indirect statement. There we go to any debt, plus we take out the applicable expenditures- capital, cash taxes, etc, and getting an operating cash flow. **[TC 2/2, p. 23]**

Committee/Staff/Observer
Some accountants would argue that the indirect versus the direct conversion is a work sheet activity. That is, if I have the number, I can essentially squeeze the differences and I can get to the direct format from the indirect. So it's just a mechanical process. Apparently, [participant C-14], you and [participant C-13] believe that there's an information element that must be different? **[TC 2/2, p. 23]**

Participant C-14
I don't think I can get cash paid to suppliers. **[TC 2/2, p. 23]**

Committee/Staff/Observer
Well, for example, one could argue that the change in accounts payable, if the trade payables are separately shown, the change in trade payables during the year plus the change in inventory cost of sales at least would give you that. It is a mechanical process. **[TC 2/2, p. 23]**

Participant C-13
The problem that rises is that there is far too many statements where trade payables are not shown separately or there is an "other" caption. **[TC 2/2, p. 23]**

Participant C-2
I understand that some proponents want to generate them purely through a mathematic process, but there is the assurance notion also. I think the point was made that the investing and financing activities sections are useful as they're presented and that's because they're presenting gross flows. The operating segment on the indirect method is purely a reconciling item and it doesn't give anywhere near the same usefulness I would say that being able to isolate cash paid suppliers would certainly be useful. **[TC 2/2, p. 23-24]**

Participant C-4
A component that would be good for our use would be assessment of the gross profit collected in the cash flow statement. Also, non recurring items are very hard to determine under the current direct method. We do find the information provided under the indirect method very useful though, and many times they're reconciling back to the direct method. **[TC 2/2, p. 24]**

Committee/Staff/Observer
Can somebody help me understand the information content in the numbers that you talked about under the direct method: collections from customers and cash paid to suppliers as opposed to the income statement numbers and as opposed to the indirect method? **[TC 2/2, p. 24]**

Participant C-2
We're interested in knowing what the actual cash streams are. Also, for bankers in any case, generally, it's the gap between those revenues that are reported as sales and the actual collections that called is upon to finance the sales or to the extent the cash stream is sufficient to support the operations. **[TC 2/2, p. 24]**

Committee/Staff/Observer
Doesn't that show up in those changes in the working capital number, changes in receivables, and changes in payables? **[TC 2/2, p. 24]**

Participant C-5
With sales, and beginning balance, you can work into it. They're strictly work sheet calculations you can make for that and it's reasonable to assume that those disbursements have been made, that all sales have been collected unless they've been charged off as uncollectible receivables. We live with it. We don't live as much with the concept of how much is actually paid to suppliers, as opposed to is trade being kept current or are they being dealt with properly? Probably it's more the status of current trade as opposed to what's the total flows to trade both in and out. **[TC 2/2, p. 24]**

Participant C-2
I think it's useful in understanding the business's operation particularly in looking at those trends over time, the differences between the accrual and the cash gross profit levels and if you don't have that cash paid to suppliers you can't isolate that. **[TC 2/2, p. 25]**

Participant C-17
There are other items appearing and sometimes lumped in the receivables, from year to year, particularly for smaller firms.

Participant C-5
One of the concerns you have in this is whether the flows have really been audited themselves. If the direct format is used, there's more of a sense that there's a verification of the gross cash flows included in the statement. Maybe it gives you a higher level of comfort. [Also included in 17(a)] **[TC 2/2, p. 25]**

Participant C-11
I have use gross cash receipts and disbursements so infrequently because I've seen it so infrequently. I'm not saying that there's value or not; I don't know because I rarely ever see it. **[TC 2/2, p. 25]**

Participant C-2
I think because banks have used a model that tries to get at this for a long time, coming out of the recession and the early 1970's, that bankers are accustomed to working with this information. **[TC 2/2, p. 25]**

Participant C-15
To what end? What are you able to identify? **[TC 2/2, p. 25]**

Participant C-2
What we're trying to understand is the differences between the accrual cycle and the cash cycle to the point where companies have to be willing to step in and finance their cash. It may help us understand how the company is financing its cash requirements, and how it's matching up with its finances against what its needs are- short term needs, long term needs, etc. **[TC 2/2, p. 25]**

Participant C-11
I have a subsidiary point to make on the indirect method. Often times, the item lumped together is depreciation and amortization. I think that there's a real absence often of good data, both in terms of what the amortization is, as opposed to depreciation of equipment. And also in a footnote context the time period for the amortization. Everyone knows that there are now new capital ratios that give different weighting allowances for goodwill of different types. And it's astonishing to me that still very well recognized companies do not disclose goodwill at all in the published financials. So I think a lot more weight has to be put on differentiating those items than has been the case. [Also included in 5(a) and 7(a)] **[TC 2/2, p. 26]**

Participant C-15
I think the concept of free cash flow was mentioned earlier. I think that would be important to be able to really work it in, I'm not sure whether it's best under the direct or the indirect method. I'm not very familiar with this direct method. It seems real nice and it's very logical, as we see interest paid, cash receivable from customers, cash to be paid to employees, etc. It's very user-friendly I think. It would be more helpful if we could get additional information such as a better breakdown of cash and expenditures, what is considered to be normal maintenance, expansion; that's the value of this. **[TC 2/2, p. 26]**

Participant C-14
The user-friendly nature of the direct method is appealing. We all are somewhat savvy users of financial statements. But someone with less experience, it just makes sense. You get the cash in, you pay the cash out. You look at the indirect method, you look at reconciliations of net income to cash that just doesn't provide a lot. **[TC 2/2, p. 26]**

Participant C-2
It's not cash flows, it's not the actual flows. It might be information about cash. But it certainly isn't trailed as far as it should go. **[TC 2/2, p. 26]**

Participant C-5
The direct method gives you more of the grosses. From the bank's standpoint, we do get to free cash flow or operating cash flow and that is never disclosed. The most common use of cash flow is to come to a free cash flow number for the investment community. And rather than have everybody in the world calculate it out themselves, it could be a good idea to have a supplemental disclosure or calculation of free cash flow. **[TC 2/2, p. 26]**

Committee/Staff/Observer
Is the thinking there to continue to provide these adjustments to reconcile net income to net cash as supplemental information? Under the current accounting standards, if you choose to make the direct presentation, then a reconciliation to the indirect method is required disclosure within the statement or in the footnotes. **[TC 2/2, p. 27]**

Participant C-15
If I lost some of the information as displayed under the indirect method, I'd be real concerned. **[TC 2/2, p. 27]**

Participant C-13
I think I hope you're hearing that we have a strong preference for the direct method including the reconciliation. Then there's a question of what level of detail we need. **[TC 2/2, p. 27]**

Participant C-5
As [participant C-2] said, there's some assumptions in there, if you don't get the level detail, for example, if you get notes receivable mixed in with accounts receivables, your calculations are going through the roof unless you can then detail out and separate out notes receivable both at the current period and the prior period. **[TC 2/2, p. 27]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 6—Cash flow statement display

a. In general, are you satisfied with current display of information in the cash flow statement?

3 _ Yes 10 _ No

b. If NO in 6a, please indicate your preference for the following: (if you checked YES in 6a, please go to question 6c).

enter
H, M, or L
as in question 4b

____H-8,M-2,L-2Display the operating portion of the cash flow statement *like a cash basis income statement*. That is, the captions in the cash flow statement would be the same as those in the income statement.

____H-8,M-3,L-1Require the *direct method* (gross cash flows from customers and for major categories of expense) of reporting cash flows from operations accompanied by a reconciliation of income to cash from operations.

Participant C-4: - Let CPAs do the conversion, although we can.
- Continue with adjustments in separate section.

____H-4,M-3,L-4Include a total titled "*free cash flow*".

Participant C-18: Have no idea what this means - free from what?

Participant C-13: How defined?

Participant C-4: Analyst job.

____H-6,M-4,L-1Develop a *fourth (separate) category* of cash flows to capture cash flows from *nonoperating, nonrecurring, or unusual activities*.

____H-1 Something else. Please describe.

Participant C-3: Trading activities of financial institutions can be volatile, and should be excluded from operating cash flow.

Participant C-14: This is the area where the most benefit can be achieved.

c. If you prefer the "direct" method of reporting cash flows (the method that displays gross cash flows of revenue and expenses), please indicate the reasons for *your* preference (If you prefer the indirect method, please go to question 7.). Indicate:

SA Strongly Agree
A Agree
N Neutral
D Disagree
SD Strongly Disagree

5(c). Cash Flow Statement–Page 20

The breakdown of gross cash flows into general categories such as cash received from customers, and cash paid to employees and vendors provides *insight that is not available* from the reconciliation of net income to cash flow (indirect method).

SA	A	N	D	SD
5	6	1		

In concept, the operating portion of the cash flow statement should *look like a cash basis income statement*. That is, the captions in the cash flow statement should be the same as those in the income statement.

SA	A	N	D	SD
7	3	2		

Participant C-2: Would be ideal, but short of that, some breakdown between direct and period expenses should be required.

Users' primary purpose in analyzing operating cash flows is to *determine free cash flows* or sustainable free cash flows.

SA	A	N	D	SD
7	5			

Participant C-2: Yes, as compared to core accrual earnings.

Creditors use gross cash flows as a means of *analyzing the "gap" in cash flows* that need financing.

SA	A	N	D	SD
4	6	2		

While in some cases users may be able to *convert an indirect presentation to a direct presentation, the result is unsatisfactory* because the gross cash flow estimates do not segregate cash flows into useful categories. That is, the change in accounts payable and accrued liabilities cannot be grossed-up to yield separate estimates of cash flows for inventory purchases and payments to employees.

SA	A	N	D	SD
4	5	2	1	

Participant C-2: Can be done as an estimate-however, this type of conversion may not screen out non-cash transactions recorded on accrual statements.

Users prefer the direct presentation because they *seek auditor association* with the presented gross cash flows.

SA	A	N	D	SD
1	2	7	2	

Something else. Please describe.

SA	A	N	D	SD

Participant C-4: It would be helpful to determine gross profit cash flows as well as income. Tie closer to the income statement.

[PMQC 2/2, p. 12-14]

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting. During the discussion, a comment was made on display.

Participant C-14
9, 11 and 13. And no particular order. Starting with number 9, display of financial information. We at one time talked about more focus in the balance sheet on liquidity going from maybe differentiating current liabilities rather than just something that matures under one year but get into how much of it is truly interest rate sensitive and how much is reflex roll over or refinancing risk. So I'd want to stress that. And also stress the things we talked about in the cash flow statement. We talked about going to a direct cash flow statement and I'm still in favor of that. 11, core earnings. I think everybody's said enough about that covers my views.

13 (financial instruments); it is very important to find a new way to assess the company's cash flow sensitivity to all those items related to financial off-balance-sheet transactions that are difficult for us to understand as they're presented today. [Also included in 5(b), 15, and 19] **[TC 3/11, p. 69-70]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 12--Cash flow statement display

a. In general, are you satisfied with the display of information in the cash flow statement?

Yes *3* No *4*

b. If you checked "no" in 12a, please indicate your relative preference for the following items by marking H, M or L in each space (if you checked "yes" in 12a, please jump to question 13).

rank
H, M, or L
as in question 10b

	High potential	Moderate potential	Low or no potential
Display the operating portion of the cash flow statement like a cash basis income statement. That is, the captions in the cash flow statement would be the same as those in the income statement.	*3*	*1*	

Require the direct method of reporting cash flows from operations (which includes a reconciliation of income to cash from operations similar to that currently provided by the indirect method).	2	1	1
Include a total titled "free cash flow".	3		1
Develop a fourth category of cash flows to capture cash flows from nonoperating, nonrecurring, or unusual activities.	3	1	
Something else. Please describe.			

c. If you prefer the direct method of reporting cash flows, please indicate the reasons for your preference by checking each of the following reasons with which you agree (if you prefer the indirect method, please skip to question 13):

	check all that apply
The breakdown of gross cash flows into general catogories such as cash received from customers, cash paid to employees, and cash paid to vendors provides insight about the company's business that is not available from the indirect method.	1
Compared to the indirect method, reporting gross cash flows under the direct method provides more insight into whether the company's reported income is "real".	1
In concept, the operating portion of the cash flow statement should look like a cash basis income statement. That is, the captions in the cash flow statement shoud be the same as those in the income statement. The direct method is closer to that concept than is the indirect method.	1

	check all that apply
It is sometimes not possible to convert an indirect presentation to the direct presentation.	
Something else. Please describe. *Participant I-12*: I rarely use these statements since they are almost meaningless for financial companies- therefore I abstain.	

[PMQI 12/9 and 1/13, P. 20-22]

[One analyst commented on the] following regarding her approach to securities analysis and financial reporting in general: [Also included in 1(a), 1(b), 6, and 15] **[BEAR STEARNS, p. 3]**

> Prefers the indirect method of presenting the statement of cash flows. (She does not use the condensed cash flow statement that is provided in the Form 10-Qs and believes that it could be eliminated.) [Also included in 1(b)] **[BEAR STEARNS, p. 3]**

AIMR's Financial Accounting Policy Committee supported development of FAS No. 95 (Cash Flows) believing that the Statement of Changes in Financial Position was an inadequate guide to changes in liquidity. Experience with the standard, however, leads to the conclusion that several provisions of the statement have not worked as intended. It was assumed that the indirect method would enable those who use financial statements to understand how reported net income differs from cash flow and to be able to reconcile the two. It was also assumed that users who wished to prepare a direct method statement would be able to do so using the data provided in the indirect method reconciliation. **[AIMR/FAF91, p. 12]**

Use of the statement results shows that our assumptions were incorrect. Due to lack of clarity in presentation, use of descriptions such as "miscellaneous," and netting, it is rarely, if ever, possible to use the indirect method to prepare a direct method statement. **[AIMR/FAF91, p. 12]**

Most analysts, therefore, have reluctantly concluded that the direct method is highly preferable because it clearly shows the sources and uses of cash segmented by operating, investing, and financing activities. Research has also shown that the individual components of cash flow from operating activities have explanatory power superior to that of cash flow from operations. **[AIMR/FAF91, p. 12-13]**

For this reason AIMR's Financial Accounting Policy Committee last year urged the International Accounting Standards Committee to require use of the direct method while maintaining a requirement to reconcile cash flow from operating activities to net income. **[AIMR/FAF91, p. 13]**

Under Precept 3 (field test question), we will discuss our belief that analyst participation in field tests could help users, accountants, issuers, and the FASB pinpoint the kind of problems that have arisen in the cash flows and deferred tax areas. **[AIMR/FAF91, p. 13]**

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(b), 2(c), 4, 5(a), 5(c), 5(d), and 13] **[KPMG BANK STUDY, p. 39]**

- Preferred historical cost financial statements supplemented with fair value disclosures [Also included in 4, 5(a), and 5(b)] **[KPMG BANK STUDY, p. 39]**

5(c). **Cash Flow Statement--Page 25**

Discussions about cash flow often suffer from lack of uniform definition of terms. The table illustrates S&P's terminology with respect to specific cash flow concepts. At the top is the item from the funds flow statement usually labeled "funds from operation" or "working capital from operation." This quantity is net income adjusted for depreciation and other noncash debits and credits factored into it. Subtract the net increase in working capital investment to arrive at "operating cash flow." [Also included in 1(b) and 1(c)] **[S&P, p. 25]**

Next, capital expenditures and cash dividends are backed out to arrive at "free operating cash flow" and "discretionary cash flow", respectively. Finally, cost of acquisitions is subtracted from the running total, proceeds from asset disposals added, and other miscellaneous sources and uses of cash netted together. "prefinancing cash flow" is the end result of these computations, which represents the extent to which company cash flow from all internal sources has been sufficient to cover all internal needs. [Also included in 1(b) and(c)] **[S&P, p. 25]**

Th
e bottom part of the table reconciles prefinancing cash flow to various categories of external financing and changes in the company's own cash balance. In the example, XYZ Inc. experienced a $35.7 million cash shortfall in year one, which had to be met with a combination of additional borrowings and a drawdown of its own cash. [Also included in 1(b) and 1(c)] **[S&P, p. 25]**

Cash flow summary: XYZ Corp.

($Mil.)	Year One	Year Two
Working capital from oper. (FFO)	18.58	22.34
Dec. (inc.) in noncash current assets	(33.12)	1.05
Inc. (dec.) in nondebt current liabilities	15.07	(12.61)
Operating cash flow	0.52	10.78
(Capital expenditures)	(11.06)	(9.74)
Free Oper. cash flow	(10.53)	1.04
(Cash dividends)	(4.45)	(5.14)
Discretionary cash flow	(14.98)	(4.09)
(Acquisitions)	21.00	0.00
Asset disposals	0.73	0.23
Net other sources (uses) of cash	(0.44)	(0.09)
Prefinancing cash flow	(35.70)	(3.95)
Inc. (dec.) in short-term debt	23.00	0.00
Inc. (dec.) in long-term debt	6.12	13.02
Net sale (repurchase) of equity	0.32	(7.07)
Dec. (inc.) in cash and securities	6.25	(2.00)

[Also included in 1(b) and 1(c)] **[S&P, p. 25]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

> [One analyst] said the bulk of information in financial statements is used by analysts but not by most individual investors. He would like one number on the cash flow statement that shows the result of operations alone, not changes in the various assets. [Also included in 1(b) and 15] **[GOLDMAN, p. 4]**

> From what has briefly been described of the [foreign] financial analysts' work, there results a series of requirements with regard to accounting data, which are but insufficiently met at present. We have broken them down into . . . major categories. [Also included in 1(b), 2(c), 2(d), 3(c) 4, 5(a), 6, 8(a), 9, 11(b), 11(c), and 15] **[BETRIOU, p. 1]**
>
> - Statements of changes in financial position. They are often published by large groups, but with partially dissimilar presentations and with definitions inadequately standardized. [Also included in 1(b) and 15] **[BETRIOU, p. 2]**

5(d). Other

Issuers of financial statements provide two broad classes of data to users. **[RMA90, p. 4]**

a. Financial statements themselves include a balance sheet, income statement, cash flow statement, and additional informative disclosures in the form of footnotes. These data are the ones required by generally accepted accounting principles and attested to by independent auditors as presenting fairly the company's financial results. Financial statements should be presented in their entirety in a single document. "Summary" annual reports, stand-alone balance sheets, income statements, and other partial statements are not acceptable. **[RMA90, p. 4]**

b. Other financial data often accompany the financial statements or are distributed separately. These data include voluntary disclosures as well as those mandated by regulatory bodies such as the Securities and Exchange Commission. These data are often of great use in evaluating and understanding financial statements and are more likely to be of benefit to users if they are contained in the same document as the financial statements, as long as they are clearly identified as being supplementary to the financial statements themselves and not covered by the auditor's report. **[RMA90, p. 4]**

Professionals and individuals alike are against creating different versions of the annual report for different audiences. In addition to believing that one group should not be deprived of information given to another group, which is perceived as a form of discrimination, they believe that those receiving more information have an unfair advantage. Even though professionals believe that they would receive the more detailed versions of annuals, and even though some individuals complain of the detail and complexity in annual reports, a majority of both groups opposes differential reporting. [Also included in 2(d) and 15] **[SRI, p. 70]**

When asked to agree to disagree with the statement, "Companies should publish different versions of the annual report for different audiences," investors expressed the following views: [Also included in 2(d) and 15] **[SRI, p. 70]**

	Professional Investors	*Individual Investors*
Agree	22.8%	30.3%
Neutral	6.7	11.6
Disagree	70.5	52.8

[Also included in 2(d) and 15] **[SRI, p. 70]**

In 1983, FERF reported on an experiment, which is still underway, exploring the concept of a "summary annual report." It would relieve information overload, while being a more useful, informative communication device for a company's shareholders and for unsophisticated investors. Thus, the summary report would become an abbreviated, efficiently formatted,

highly readable successor to today's annual report. Those needing more information would still have access to the SEC Form 10K. [Also included in 2(d) and 15] **[SRI, p. 70]**

This study has shown that those aspects of summary reporting that clarify, summarize, present in more understandable form, and add value to annual report information would be well received, but reducing the amount of information included in the annual report would not be. Many of the suggestions offered for improving the annual report had to do with the need for more information, rather than less, and for information with a higher added value. [Also included in 2(d) and 15] **[SRI, p. 70]**

[Equity sell-side] analysts employ a literal definition of nonrecurring income statement items, which are usually referred to as "one time" items. They take notice of reported nonrecurring items as listed below continuing operations and also note the effect of new accounting rules. One report contained a section entitled "Non-operating earnings - A Source of Confusion in the Past". [Also included in 1(b), 1(c), and 5(a)] **[PREVITS, p. 15]**

[Equity sell-side analysts] also identify "potential" nonrecurring items contained in continuing operations, and often report EPS net of these items, as in the case of the analyst who noted "several unusual items" included in continuing operations. Correspondingly, a number of analysts report operating earnings per share, which of course is not required under GAAP, or compute an "adjusted earnings" number which includes all items judged to be nonrecurring, and corresponding EPS. Restructuring charges are an example of one common item often removed in analysts EPS reports. Occasionally analysts identify a nonrecurring cost but are unable to estimate an amount. In one case an analyst was unable to determine the amount of a corporate relocation charge buried in continuing operations. In another report the relocation charge of the company was identified in continuing operations and removed in calculating EPS. [Also included in 1(b), 1(c), and 5(a)] **[PREVITS, p. 15-16]**

[Context] Meeting of the Investor Discussion Group on January 13, 1993. Part of the meeting was devoted to the topic of display.

Committee/Staff/Observer
It has been a bit of a surprise to the Special Committee about the opportunity that display presents to help you. Yet, I don't sense the kind of burning enthusiasm on your part that display can really help you all that much. I see real opportunities here that accountants haven't thought much about before and we have some good ideas on the table. But I don't see the enthusiasm in your eyes about this subject. **[TI 1/13, p. 41]**

Participant I-12
The notion of segment reporting is a big display issue, but the substance should drive the display. The display issues should fall from the resolution of the substantive issues. [Also included in 3(e)] **[TI 1/13, p. 41]**

Participant I-11
From my standpoint, I'm reasonably satisfied with the display in the body of the financial statements. It's not ideal, but O.K. **[TI 1/13, p. 42]**

Participant I-7
Which goes back to what I said before. You don't necessarily have to change the historical display of either the balance sheet or the income statement, but there is a lot of information that we want that doesn't have to show up in the body of the P&L or the balance sheet, but could be provided notationally. **[TI 1/13, p. 42]**

Participant I-8
That's the operative thing; if a change in display doesn't give you any more information, just rearranges it, you don't get any great enthusiasm. If there is additional information provided, then we would all be for it. **[TI 1/13, p. 42]**

Participant I-14
In all this, a lot of the issues are specific to particular industries. I think the issues that are important within each industry should be reflected in the display of companies within that industry. That would be very helpful. Some things are important in one industry and not in another. **[TI 1/13, p. 43]**

[Context] Meeting of the Creditor Discussion Group on December 8, 1992. Part of the meeting was devoted to the topic of creditors' objectives and approaches. During the discussion, comments were made on display.

Participant C-6
Many times in my business we virtually get no disclosure at all. For example, a balance sheet and income statement with no footnotes. So, it's incumbent upon the lender to go in and query management and dig up pertinent information that we need to make any kind of educated decision. [Also included in 2(d) and 15] **[TC 12/8, p. 27]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, comments were made on display.

Participant C-11
I would agree with all of these comments. I think that if we're talking about going concerns, the need for fair value information and its reliability and usefulness, in terms of knowing how well the business is doing, is lot less and definitely that puts it into supplemental status. I think we have a great problem in general as to knowing when a company is in distress, and when we have to take a different accounting approach. So far, all the comments have been focused on revaluing at market values specific types of assets. Nobody's mentioned liabilities. But I think we can't forget that. I want to make a comment that in an increasingly distressed situation, a company doesn't have to, necessarily, sell one particular type of loan or securities or whatever. There is often an option of selling part of its business. And so when you're

talking about what is the fair or market value of an entity, it isn't necessarily just individual assets. It can be a business component. And the way you value the component of the company's business is going to be a lot different then. And it may be even more successful a way to take care of a distress situation than just selling its individual loans. I think if you're thinking about market value, you have to think in a more complex way and not just value the specific individual assets and liabilities and think you've done the job. I feel strongly about that. I'd also make just a general comment about supplemental information. I don't ascribe more importance to something because it's in a footnote, as opposed to being in a supplemental schedule of some sort. We have all kinds of supplemental schedules that are required and that's where you can get some of your best data. As a user, I don't have a phobia about needing to have it on the balance sheet or a footnote, per se. [Also included in 2(a), 2(b), and 4] **[TC 2/2, p. 7-8]**

Participant C-5
I'll make this comment about the database thinking. The database is a facility that clearly does allow you to make some cuts in data. [Participant C-11] mentioned earlier about all the footnote disclosures. We don't get those footnotes in databases. And so I would hope that even if they are supplemental or footnote type disclosures, that there's at least enough structure that those can continually be databased in such a way that whether it's unrealized gains, they will be included. So there is value to database. I want to say that there is also this individual analysis. And that's where the world is still going to be at. [Also included in 4 and 16(a)] **[TC 2/2, p. 11]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting. During the discussion, comments were made on display.

Participant C-10
9 (display), 11 (core earnings) and 12 (interim reporting). Basically try to improve cash flow information. Under 9, I think there's too much alternative uses here. I'd like to get more consistency. And like core earnings, one of the things that we're always doing is pulling out depreciation, normal depreciation and extraneous or non-normal. Most companies will just lump it in one figure. On interim reporting I just think that we have to keep hitting on this issue with you folks, otherwise you'll back up on us. [Also included in 5(a) and 15] **[TC 3/11, p. 72]**

Participant C-6
9 (display), most importantly their consistency in display of information. Because I feel if I get consistent year to year or quarter to quarter, I can analyze it a lot better and draw my own conclusions. 12, interim reporting, which we always find to be a difficult thing to achieve but we always push for interim statements. And 18, improving auditing. [Also included in 15] **[TC 3/11, p. 73]**

Most [CIC] subcommittees agree [that] the following suggestion seems appropriate: [Also included in 1(b), 2(b), 2(c), 3(b), 3(d), 5(a), 11(a), 13, and 16(b)] **[AIMR/CIC92, p. 3]**

- Prompt communication of significant developments. This includes major changes in strategy as well as business conditions. This would also include full disclosure of the anticipated financial impact from new accounting principals: FAS 107 (Fair Value), FAS 106 (Retiree Health Care), FAS 109 (Income Taxes). [Also included in 1(b), 13, and 16(b)] **[AIMR/CIC92, p. 4]**

[The CIC has] cited numerous examples of disclosure formats that were particularly useful and insightful. More than one subcommittee, for example, pointed out the utility in trends analysis of having 11 years of historical data made available in a table in the annual report. Still others noted the growing value of factbooks, many of which provide additional layers of detail, not only about a particular company's operations but also about the industry in which the company operates and the broader economic climate as well. [Also included in 1(b) and 13] **[AIMR/CIC92, p. 4]**

User Survey Results, Users: The comments made by analysts in the focus group meetings were generally consistent with and supportive of the survey results. Although direct comparisons are not possible, inferences were drawn. The table below presents the main conclusions from the survey with responses from the focus groups: [Also included in 2(o), 2(c), 4, 5(a), 5(b), 5(c), and 13] **[KPMG BANK STUDY, p. 39]**

- Viewed uniform methodologies, assumptions, and presentation of fair value information as very important [Also included in 4 and 5(d)] **[KPMG BANK STUDY, p. 39]**