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Database of Materials on Users' Needs for Information
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VOLUME 2

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SPECIAL COMMITTEE ON FINANCIAL REPORTING
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

II Material From Documents Authored by Users or Based on Research Directly With Users *(continued)*

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

(continued)

6. Unconsolidated Entities

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	□

6. Unconsolidated Entities

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]**

- Lenders find consolidated financial statements useful in presenting an overview of the total economic resources controlled by the shareholders of a single (parent) corporation. However, consolidating statements are essential to lenders who must be able to assess the financial capabilities of each individual legal entity within the group. **[RMA90, p. 7]**

  Consolidated financial statements should include all subsidiaries controlled by the parent. Other investments should be recorded at cost. Foreign subsidiaries must have their accounts adjusted to United States GAAP and their amounts translated into U.S. dollars prior to consolidation. Separate financial statements of foreign companies are most useful when: (1) they are expressed in U.S. dollars, and (2) they include a schedule that reconciles the financial effects of the foreign GAAP either to U.S. GAAP or to standards promulgated by the International Accounting Standards Committee (IASC). **[RMA90, p. 7]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on the types of information investors use and the way they use that information to achieve their objectives, one investor made a comment on unconsolidated entities.

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 5(a)] **[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.

Committee/Staff/Observer
Our next few questions relate to unconsolidated entities. By unconsolidated entities we mean investments in (1) companies that are not subsidiaries, (2) joint ventures, and (3) partnerships that are not consolidated. Currently, in the U.S., most investments in unconsolidated entities are accounted for using the equity method. As you know, under that method, the investment and the investor's share of earnings or losses from the investment is shown in the balance sheet

and the income statement as single amounts. In most cases, additional information about the investee's results and financial position are provided in notes to the investor's financial statements; the quantity of information depends on the significance of the investment. **[TI 12/9, p. 31]**

The meeting materials identified and illustrated two other ways for accounting for investments in unconsolidated entities: (1) proportionate consolidation, and (2) expanded equity method. **[TI 12/9, p. 32]**

Assuming that the information in the notes to the financial statements remains the same as current practice, our question is: which display method, current practice, expanded equity, or proportionate consolidation, would you favor for investments in unconsolidated entities? Does your answer depend on the types of investments or on the degree to which the investee's operations are integrated into those of the investor? **[TI 12/9, p. 32]**

Participant I-11
Proportionate consolidation ranks right there in my mind with computing per-share data on segments. I don't know what those numbers mean; I don't think anybody knows. The expanded equity method is a more useful way of showing that information. **[TI 12/9, p. 32]**

Participant I-8
I second the motion. **[TI 12/9, p. 32]**

Committee/Staff/Observer
There is a general negative reaction for proportionate consolidation? **[TI 12/9, p. 32]**

Group
Yes. **[TI 12/9, p. 32]**

Committee/Staff/Observer
Why? **[TI 12/9, p. 32]**

Participant I-8
Meaningless number in my mind. **[TI 12/9, p. 32]**

Participant I-5
You lose information with proportionate consolidation. For example, do they have $54 million of cash they could spend or $41 million? **[TI 12/9, p. 33]**

Committee/Staff/Observer
Expanded equity is a better method than the equity method? **[TI 12/9, p. 33]**

Participant I-8
Yes, you're bringing information from the notes to the financial statements so you see it right away. **[TI 12/9, p. 33]**

Committee/Staff/Observer
It's better but it really is not necessary, is it? **[TI 12/9, p. 33]**

Participant I-8
No, you have it in the notes. **[TI 12/9, p. 33]**

Committee/Staff/Observer
Anybody feels this area of unconsolidated entities is a major problem? **[TI 12/9, p. 33]**

Participant I-7
Only when we're not getting the information. In my industry, joint ventures are becoming "de rigueur". What we're beginning to see in the annual report is, for example in the case of [name deleted], a disclosure that they have joint ventures with companies which have total sales of over $2 billion. What's in that? We need some more information; all I have is $2 billion. **[TI 12/9, p. 33]**

Participant I-6
I would also plead for more information. Too many of my companies have equity line items in the financial statements which probably average $10-$20 million a year, but that's probably one company making $30 million and the other three losing $10 million. So you really have no idea of what's in there and there's no way of forecasting it. In the footnotes, every single company in the equity line item should be broken out with a condensed balance sheet and income statement. **[TI 12/9, p. 33]**

Participant I-12
I think materiality is an important question here. If [name deleted] had to disclose every single one of its minority-held investments, it would go on for pages and would give me no incremental value. That particular line item for most companies I cover might consist of anywhere from 3 to 24 companies and is not even material in the overall context of the balance sheet or the income statement or the net income line. From a materiality viewpoint, the cost-benefit doesn't seem to work out. My concern is that, with the growth of joint ventures and minority-held operations, we're approaching the Japanese model which I find a bit frightening. So we need some disclosure, I just don't know what the right disclosure is. **[TI 12/9, p. 34]**

Participant I-4
In some cases, it's not very clear the nature, not only the profitability, of the unconsolidated entities (joint ventures, general partnerships, etc.). And where they're all lumped together, it's incredibly misleading. **[TI 12/9, p. 34]**

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 5(a)] **[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 5(a)] **[TI 12/9, p. 34]**

Participant I-9
It hasn't been an area of great concern in my industries in the past, but it could be in the future. There's been a trend of little companies that are taking 10-15% interest in private companies with the option to buy part or all of it in the future. They're doing this to keep the losses off their income statement. It's something that's coming; so I think the accounting profession needs to look at it harder than they have in the past. **[TI 12/9, p. 34-35]**

Committee/Staff/Observer
It seems to me that you clearly want either the current equity method or the expanded equity method, not the proportionate method, and with more information in the notes. **[TI 12/9, p. 35]**

Participant I-8
But the materiality aspect has to be taken into account. **[TI 12/9, p. 35]**

Participant I-6
But are we talking about materiality of everything lumped into one? **[TI 12/9, p. 35]**

Participant I-8
Each specific one. **[TI 12/9, p. 35]**

Committee/Staff/Observer
Currently, SEC regulations require disclosure of the full financial statements of an investee if the investment meets the size criterion. If investments in unconsolidated entities do not meet the size criterion but are still significant in the aggregate, certain summarized information is provided, as listed on page 11 of the meeting materials. Do you find the current disclosure of information about unconsolidated entities acceptable? If not, what information, in addition to the information currently provided, would you use? **[TI 12/9, p. 35]**

Participant I-6
I would like more information. I have companies that have to disclose that information, but it just starts you down the trail of asking for more information. **[TI 12/9, p. 35]**

Committee/Staff/Observer
Do you have a problem with the 20% level? Would you like to see it lowered? **[TI 12/9, p. 35]**

Participant I-6
Yes, I would like to see it lowered. I would like the same definition of materiality used as in other issues, which is a lot lower. **[TI 12/9, p. 36]**

Participant I-4
I would agree with [participant I-6]; the 10% number is probably a better benchmark. I have found historically that this is the area where there is abuse in the sense of moving earnings in

and out, smoothing things out, in these lines. The greater amount of disclosure, the greater the attempt would be made to understand it. **[TI 12/9, p. 36]**

Participant I-5
I want to concur with a lower level than 20%. **[TI 12/9, p. 36]**

Participant I-12
If a company gets up to a 20% level, usually that's sufficiently material. I don't see any reason to lower it. **[TI 12/9, p. 36]**

Committee/Staff/Observer
I didn't mean the 20% test for using the equity method; I meant the other 20% test for disclosure of information where you are on the equity method. **[TI 12/9, p. 36]**

Committee/Staff/Observer
I think [participant I-4] understood that and he is in favor of more disclosure with a lower threshold. **[TI 12/9, p. 36]**

Participant I-4
Yes. **[TI 12/9, p. 36]**

Committee/Staff/Observer
[Participant I-6] suggested more information, I would like to clarify that. What additional information do you want? **[TI 12/9, p. 36]**

Participant I-6
A full set of financial statements and production data! **[TI 12/9, p. 36]**

Committee/Staff/Observer
Let's assume the threshold for each investee is lower than 10%. Do you really mean that you would want a complete set of financial statements? **[TI 12/9, p. 37]**

Participant I-6
Yes, they could be in the footnotes but I would like a full set of financial statements. If management says it's a meaningful part of the company, I would like to understand why management thinks so and be able to evaluate over the years whether those are good investment decisions. We also have specific examples like [name deleted] where they use equity accounting to hide major portions of details on those operations. **[TI 12/9, p. 37]**

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 2(c)] **[TI 12/9, p. 37]**

Committee/Staff/Observer
I presume you also want some discussion of the operations in addition to quantitative information. **[TI 12/9, p. 37]**

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 5(a)] **[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 5(a)] **[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 5(a)] **[TI 12/9, p. 38]**

Committee/Staff/Observer
I think the comments so far have been based on unconsolidated entities who trigger the disclosure hurdle, whether it's 20% or 10%. For other entities that do not trigger the hurdle individually but do in the aggregate, we currently have aggregate disclosure to be made. Do you find the aggregated information helpful? **[TI 12/9, p. 38]**

Participant I-6
The only thing that I find it helpful for is to remind me to ask management about it and I'm usually told it's not material. **[TI 12/9, p. 38]**

Participant I-4
I think it's helpful if you know through other sources, mainly management, what's in it. **[TI 12/9, p. 38]**

Committee/Staff/Observer
It seems to me that the answer to [the] question is that it's meaningless in the aggregate unless you get the breakdown. **[TI 12/9, p. 38]**

Participant I-5
But there's some value to having it in there. **[TI 12/9, p. 38]**

Participant I-8
It's obviously better than nothing. **[TI 12/9, p. 38]**

Participant I-4
Well, I'm not so certain about that. I think it can be very misleading if you don't know what is in there. **[TI 12/9, p. 38]**

Participant I-12
It triggers the "red alert" sign. We all have our red alert button and if you see some numbers that look strange, it triggers that button. **[TI 12/9, p. 39]**

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 2(c)] **[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 2(c)] **[TI 12/9, p. 39]**

Participant I-9
What I would suggest is something like segment accounting where you list the affiliates, the ownership, the sales, the earnings, the debt equity ratio, and leave it then to the analyst to follow up and ask the relevant questions if that triggers some interest. **[TI 12/9, p. 39]**

Participant I-12
One of the things that worries me is, 5-7 years ago, there was a company that had a 15% interest in some subsidiary but it basically pledged its balance sheet and its full resources to that subsidiary and ended up going bankrupt because of a problem in this minority-owned operation. In general, that's a rare instance because there are usually enough other factors that we would see. But I think that kind of situation, instances where the whole company is at stake, needs to be revealed. [Also included in 10(d)] **[TI 12/9, p. 39-40]**

Participant I-8
There is a current disclosure requirement on contingent liabilities; I would think that situation would be covered. [Also included in 10(d)] **[TI 12/9, p. 40]**

Committee/Staff/Observer
It's hard for me to believe that if the investor company had somehow signed its life away and had this contingency, that there wouldn't be some disclosure. [Also included in 10(d)] **[TI 12/9, p. 40]**

Committee/Staff/Observer
All the disclosures we are talking about are triggered in the first instance when an investor has a 20% or more interest in another entity. Are any of you concerned about disclosure of information when the % interest is 19%, for example? In that case, there is nothing disclosed; the investment is carried at cost, there is no supplemental financial statements or additional information required about the investment. **[TI 12/9, p. 40]**

Participant I-4
The question is at what point do you feel comfortable. This is just a qualitative question about materiality. **[TI 12/9, p. 40]**

Committee/Staff/Observer
You could have a 19% investment that could have a more significant impact on the company than a 30% investment in a small entity. **[TI 12/9, p. 40]**

Participant I-6
I would look at it a little bit differently. One of the things that's important to me is earnings, much more than cashflows. When you're equity accounting, it affects my earnings; when you use cost accounting, the only thing that is going to affect my earnings is the receipt of cash in the form of dividends. If we want to change that threshold level, I would much rather change it to having cost accounting for investments up to 50% and have only cash affect my earnings. I am a bit drastic, but the magic number is not 19% or 20% but rather what happens to earnings. **[TI 12/9, p. 41]**

[Context] Meeting of the Investor Discussion Group on March 17, 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 unconsolidated entities.

Participant I-11
Interim reporting, accounting for financial instruments, and unconsolidated entities [are my priorities] and there I favor the expanded equity method. [Also included in 15] **[TI 3/17, p. 66]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 9

Currently, in the U.S., most investments in unconsolidated entities (20-50% ownership interests) are accounted for using the <u>equity method</u>. Under this method, the investment is shown in the balance sheet of the investor as a single amount. Likewise, the investor's share of earnings or losses from its investment is ordinarily shown in the consolidated income statement as a single amount. In most cases, additional information about the investee's results and financial position are provided in notes to the investor's financial statements.

There are at least two <u>other</u> ways that have been proposed for accounting for investments in unconsolidated entities:

•*Proportionate consolidation*: The investor records its proportionate interest in the investee's assets, liabilities, revenues, and expenses on a line-by-line basis and combines the amounts directly with its own assets, liabilities, revenues, and expenses, and those of its consolidated subsidiaries. For example, if the investor owns 30% of an incorporated joint venture, 30% of the cash balance would be added to the group's cash balance, and similarly for 30% of all of the investee's assets, liabilities, revenues, and expenses.

•*Expanded equity method*: The investor's share in the total current and noncurrent assets and liabilities and in the total revenues and expenses is displayed separately from the consolidated assets, liabilities, revenues, and expenses in the consolidated financial statements. The subtotals would be labeled appropriately (for example, "Current Assets of Investee") and would be added to the investor's totals. This reporting method is a compromise between the "one-line" display under the equity method and the combined display of the investor's and the investee's assets, liabilities, revenues, and expenses required under the proportionate consolidation method.

Assuming that, under the equity method, the information in the notes to the financial statements remains the same as current practice, which display method (equity, proportionate consolidation, or expanded equity) would you generally favor for investments in unconsolidated entities?

	EQUITY	PROPORTIONATE	EXPANDED EQUITY
a. Investment in operations over which the *investors share control*—that is, no single investor controls the operations (unincorporated joint ventures)	7	2	6
b. Investments in companies over which the *investors share control*—that is, no single investor controls the company (incorporated joint ventures)	8 2	5	
c. Partnerships in which the *partners share control*—that is, no single partner controls the partnership	7	2	6
d. Investments in companies over which the *investor has "significant influence"* (the basis for using the equity method in APB Opinion 18).	5 2	8	
e. Would your answer(s) also depend on whether the investee's operations were or were not integrated with or otherwise related to the investor's operations?			

9 _ YES

8 _ NO

Participant C-3 - I find the expanded equity method a little confusing to the casual reader. Also, it gives management a potential "loophole" in avoiding the more relevant "proportionate" disclosure. Thus, if we're going to recommend a change, I'd make it consistent. Go with proportionate.

Participant C-15 - [W]e often encounter situations where even a less than 50% owned entity could have significant impact on "parent" company because of keep well agreements, etc. The analysis of these entities is subjective and frequently we ask for full disclosure of financials.

Participant C-4 - Yes, if significant interco transactions, prefer expanded equity. Also, prefer expanded equity if the investment includes a guarantee of debt of investee or if investors are in any way liable (partnership).

Participant C-11 - I do not like proportional or expanded equity. If the entity is significant or material, I want separate, complete financials in the footnotes.

[PMQC 12/8, p. 21-23]

QUESTION 10

Currently, SEC regulations require disclosure of the full financial statements of an investee (as part of the consolidated financial statements) if the investment meets a size criterion (broadly, if the investor's share in the total assets or the income of the investee exceeds 20% of the investor's consolidated assets or income). If investments in unconsolidated entities do not meet the size criterion but are still significant in the aggregate, the following summarized information must be provided:

•Current and noncurrent assets and liabilities

•Interests of the other investors

•Redeemable stock

•Net sales or gross revenues

•Gross profit or loss (or cost and expenses applicable to net sales or gross revenues)

•Income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle

•Net income or loss

a. Would your answer(s) to QUESTION 9 change if you received detailed information about an investee in notes to the financial statements?

6 _ **YES**

9 _ **NO**

Participant C-13 - Probably - depends on degree of detail.

b. If detailed information is reported in notes, would you be indifferent about which of the three reporting methods is used in the financial statements?

9 _ **YES**
7 _ **NO**

Participant C-3 - If it's important, put it in the financials. Disclosures in footnotes should not be an alternative to proper accounting.

Participant C-12 - I still don't like proportionate.

Participant C-11 - I think the inclusion of such data in the financial statements can be misleading.

Participant C-2 - Except I do not favor proportionate consolidation - it obscures the financial position of the investor.

Participant C-13 - Subject to above. Consolidating statements would be best detail.

c. Is the current disclosure of information about unconsolidated entities acceptable?

	YES	NO
	5	11
If NO,:		
•Would you want the full financial statements of all unconsolidated entities?	7	3

•If only summarized information is available, what information, in addition to the information currently provided (as listed above), would you want?

Participant C-3- The companies I follow have unconsolidated investments, but the results of those entities are not "significant" enough to warrant disclosure. Understanding the nature and extent of investments in less than 20% entities goes a long way in helping to evaluate the consolidated company's future cash flow/earnings potential, since these investments can be sold and gains recognized. Accordingly, I would like disclosure in the aggregate, of investments in unconsolidated entities if the sale of this and investments, in the aggregate, could be material to net income.

Participant C-15 - Rev's - Oper Inc - deprec - Int exp
Current Assets - Pt profits - PPE - Goodwill - Cash and equiv - A/R - Inventories
Current Liabilities - (incl STD) A/P - LTD - Def. taxes - Equity

Participant C-10 - Cash flow available to investor company.

Participant C-12 - Overkill.

Participant C-4 - Only if unconsolidated entity is hiding a significant off balance sheet liability or if the equity investment represents a substantial portion of the net worth of the investor. Full balance sheet disclosure, particularly current asset and liability accounts breakdown.

Participant C-8 - Interest bearing debt.

Participant C-11 - The question comes down to what is significant. This can be relative to results, cash flow or the key balance sheet items. In other words, the answer can be company specific.

Participant C-16 - CA/CL/FA/LTD/CPLTD
Sales/GM/OP Income/NPBT
Gross/Net Cash Flow

Participant C-2 - IF the disclosures are provided, they are generally sufficient for analysis purposes. Additional questions or concerns can be addressed to the borrower directly.

Participant C-13 - Consolidating. Cash flow data, particularly cash flows between the unconsolidated entities.

[PMQC 12/8, p. 23-25]

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

6. Unconsolidated Entities--Page 13

At the December 9, 1992 meeting, we discussed three approaches that have been proposed for accounting for investments in unconsolidated entities:

- Equity method, which is currently used for accounting for most investments in unconsolidated entities
- Expanded equity method
- Proportionate consolidation.

A brief description of each method was provided on pages 9-10 of the reporting materials for the December 9, 1992 meeting; an example of each reporting method was provided on pages 12-13.

QUESTION 6

a. Assuming that, under the equity method, the information in the notes to the financial statements remains the same as current practice, which display method (equity, proportionate consolidation, or expanded equity) would you generally favor for investments in unconsolidated entities?

	Equity	Proportionate	Expanded Equity
• Investment in operations over which the *investors share control*--that is, no single investor controls the operations (unincorporated joint ventures)	*3*	*1*	*3*
• Investments in companies over which the *investors share control*--that is, no single investor controls the company (incorporated joint ventures)	*3*	*2*	*2*

	Equity	Proportionate	Expanded Equity
• Partnerships in which the *partners share control*--that is, no single partner controls the partnership	*3*	*1*	*3*
• Investments in companies over which the *investor has "significant influence"* (the basis for using the equity method in APB Opinion 18)	*2*	*3*	*2*

Participant I-12: Current practice is fine, although the expanded equity method might help clear up the sources of revenues and expenses. Control- or lack thereof- and relative impact on income statement are key factors.
Participant I-9: Almost all of my work would be with incorporated joint ventures.

b. Would your answer(s) also depend on whether the investee's operations were or were not integrated with or otherwise related to the investor's operations?

Yes	*2*
No	*5*

If YES, in which way?
Participant I-11: If the investee was in a substantially identical line of business and generally viewed by outsiders as part of/related to the investor. I recognize that usually this will be a situation that meets the "significant influence" standard- but perhaps not always.

Participant I-12: The investee provides a critical product/service or the investor extended guarantees of any sort with regard to the investee.
[PMQI 12/9 and 1/13, p. 8-9]

QUESTION 7

Currently, SEC regulations require disclosure of the full financial statements of an investee (as part of the consolidated financial statements) if the investment meets a size criterion (broadly, if the investor's share in the total assets or the income of the investee exceeds 20% of the investor's consolidated assets or income). If investments in unconsolidated entities do not meet the size criterion but are still significant in the aggregate, the following summarized information must be provided:

- Current and noncurrent assets and liabilities
- Interests of the other investors
- Redeemable stock
- Net sales or gross revenues
- Gross profit or loss (or cost and expenses applicable to net sales or gross revenues)
- Income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle
- Net income or loss.

6. **Unconsolidated Entities--Page 16**

a. Would your answer(s) to QUESTION 6 change if you received detailed information about an investee in notes to the financial statements?

Yes *1*	No *6*

Participant I-12: This question involves the issue of a "portfolio" of investments- aggregation might be very important here.

If YES, in which way?
Participant I-11: To the extent to which detailed information is included in the notes, simple equity calculation on the face of the balance sheet would be adequate.

b. If detailed information is reported in notes, would you be indifferent about which of the three reporting methods is used in the financial statements?

Yes *4*	No *2*

If NO, please explain
Participant I-11: Proportionate is worthless.
Participant I-12: Again- issue of "portfolio"- may be more important for small companies with few such investments. Individual investee information could be incredibly cumbersome for large companies.

c. Is the current disclosure of information about unconsolidated entities acceptable?

Yes *2*	No *5*

Participant I-9: This seldom comes up as a practical matter on the stocks that I follow. On occasion, it does as with [name deleted] which inflated earnings by excluding unconsolidated new ventures recording losses - i.e. it is a potential area of abuse in some companies.
If NO:

- Would you want the full financial statements of all unconsolidated entities?

Yes *2*	No *5*

- If only summarized information is available, what information, in addition to the information currently provided (as listed above) would you want?

  Participant I-7: only meaningful information
  Participant I-8: 1) Significant cash flow items, 2) any guarantees of debt or otherwise
  Participant I-11: SG&A; pretax income; extraordinary items; receivables; inventories; intangibles; composition of current liabilities; nature of non current liabilities
  Participant I-6: Revenue and operating profit by segment <u>or</u> products
  Participant I-12: Just material (vis-a-vis income statement or balance sheet risk) entities -- key sources of revenues and expenses

[PMQI 12/9 and 1/13, p. 10-12]

[One analyst commented on the] following regarding her approach to securities analysis and financial reporting in general: [Also included in 1(a), 1(b), 5(c), 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 1(b) and 15] **[BEAR STEARNS, 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), 4, 5(a), 5(c), 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, 5(a), 8(a), 9, 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 1(b) and 15] **[BETRIOU, p. 3]**

7. Intangible Assets

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	☐

7(a). Goodwill

[Context] The following brief summary of the topic "Accounting for Intangible Assets," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

> Current accounting for intangible assets has great potential for confusion. Purchased intangibles are initially recorded at cost and amortized over periods of time that often are arbitrarily determined. Self-developed intangibles are for the most part not recorded. Financial statement comparability between and among enterprises suffers accordingly. Our contemplation of this situation leads us to two major recommendations that we believe will increase comparability. Both recommendations are controversial and should be considered in the light of the full discussion of them in the report. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. viii]**
>
> First, we advocate capitalization of all executory contracts with an initial duration of more than one year. We would include not only leases, but also employment agreements and similar contractual arrangements. Our recommendation does not advocate any change that would weaken the standards governing revenue recognition. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. viii]**
>
> Second, we recommend that purchased goodwill will be written off at the date it is acquired. We believe that it is an important number, but only to depict a value at a particular date, a value that undoubtedly is subject to rapid and sizable change thereafter. We cannot see how its presence on the balance sheet is of use in estimating a firm's future cash flows or gauging its contemporaneous value. Therefore, we recommend banishing goodwill from an enterprise's list of assets, but preserving a record of it by having it show as a separate and distinct reduction of shareholders' equity. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 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.

> An earlier part of this report, [pp. 17 and 18, quoted in 7(b)] discusses implications for financial reporting of the rise in the proportion of economic activity attributable to the service sector. One ramification is its exacerbation of the persistent and vexing question of how to account for intangible assets. Service businesses are, with certain notable exceptions such as telecommunications, generally labor intensive. These firms have few tangible assets and in many cases have balance sheets that under conventional accounting show meager or even negative owners' equity. In fact, however, they may possess sizable unrecorded economic resources in the form of anticipated future cash flows. Yet, under traditional accounting methods, the value of those future cash flows is recorded only when: (a) they are acquired in a purchase transaction with an unrelated party, or (b) the anticipated cash finally is received. On the other hand, equity investors and lenders are forced to acknowledge the value of future cash flows in order to make sensible investment and lending decisions in competition with other

rational suppliers of capital. Our views on this matter are set forth below. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 29]**

Nature of the Problem

All economic value must ultimately result in cash inflow(s). In fact, it is future cash flows to which both equity investors and lenders look for a return on and return of their investments. Tangible assets offer an additional measure of comfort in that they usually but not always have some value at liquidation even though it may be modest. Furthermore, tangible assets are, without significant exception, acquired in exchange transactions with outsiders and, except for business combinations, are usually acquired individually or in groups of related items. Even when acquired in a basket purchase, it usually is not particularly difficult to obtain competent data to allow their values to be reported separately. Therefore, ordinarily there is little problem in recording at least the initial values of tangible assets. The same is true of intangible assets (patents, franchises, etc.) purchased separately. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 29]**

Major problems arise with accounting for intangible assets that either are self-developed or acquired in a business combination. Other problems emanate from intangibles whose sole value comes from their ability to enhance the cash flows of a going concern. For example, how are analysts sensibly to compare two firms, one of which has developed strong brand names through sizable expenditures none of which has been capitalized (say, the Proctor and Gamble Company), the other of which has grown by purchasing the brand names of others (say, RJR Nabisco)? How are analysts to find useful the financial statements of cable television and other media firms that have significantly negative net worths because they have borrowed against future cash flows and used the proceeds either to cover reported losses or to make payments to stockholders?[7] [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 30]**

Sources of Future Cash Flows

Intangible assets comprise all sorts of contractual, institutional and informal arrangements, all of which are characterized by associated expectations of future cash inflows. Many of these values are attributable to human beings who are talented, well-trained, acculturated, or otherwise able and willing to contribute to the enterprise's economic well-being. Arrangements between the firm and its employees vary. Some, mainly senior managers and others who make unique contributions, serve under individual contracts. Some of those contracts may contain provisions that activate sizable payments at or after the individual's separation from the firm, so-called "golden parachutes" and similar arrangements. At the other end of the scale are collective bargaining agreements with unions and other worker organizations. In between are the ordinary day-to-day, month-to-month continuances of employment and service. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 30]**

Future cash flows may also be attributed to franchises. That term is used in its broadest sense to include not only contractual arrangements, but also other exclusive accesses to customers. A brand name might be said to be a "franchise." For example, one thinks of the position of the Campbell name in canned soup, H.J. Heinz in ketchup or Bayer in aspirin. Anther

[7] In 1988, King World Productions, syndicators of the television programs, *Jeopardy*, *Wheel of Fortune* and *Oprah Winfrey*, was reported to have a $30 million negative net worth for exactly that reason. *Forbes*, July 11, 1988, page 83.

example of an exclusivity is a long-established reputation, such as those carried by the "Big Six" accounting firms, certain major law firms, advertising agencies, actuaries, consultants and a host of other professional services providers. Health care organizations are very likely to have franchises arising from both their reputations and their proximity to patients. A news distributorship in Manhattan, New York City, is worth more than one in Manhattan, Kansas. The examples could go on and on. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 30]**

In many cases expectations of future cash flows may dissipate in the face of competition and are able to continue to flourish only if the enterprise continues to support them with attention and expenditures. Alternatively, exclusive rights may be obtained either under law (patents, copyrights, trademarks, etc.) or by contract. An enterprise may contract for a franchise (in the narrow sense of the word) for human services, for services to be provided by another organization, or for the rights to use real assets (plant and equipment) for limited periods of time. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 30]**

All of the above are intended to be an illustrative but not exhaustive list of the incredible variety of sources of intangible value. All of them illustrate cases of valuable assets that, with two exceptions, are not recorded. One exception is when the asset is purchased in an arms-length exchange transaction. The other exception is for certain lease agreements that meet one of the conditions that qualify them as capital leases. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 31]**

The Problem of Goodwill

We are not concerned with the theory of goodwill except as it pertains to the usefulness of financial statements to analysts. We view goodwill as the amount that an enterprise as a whole is worth in excess of the values of its individual assets less individual liabilities. We are wholly in agreement with Opinion No. 16 of the Accounting Principles Board with respect to the computation of goodwill. We also agree that there is no reliable valuation of it in the absence of an exchange transaction involving controlling interest in an entire enterprise. We balk at the notion of goodwill being recorded without the authentication of a transaction. **[AIMR/FAPC92, p. 31]**

What we disagree with is Accounting Principles Board Opinion No. 17 which allows purchased goodwill to linger on the balance sheet for up to forty years. Once it has been established for the record how much was paid to acquire goodwill, it ought to be removed from the list of assets forthwith.[8] That would remove a major impediment to comparing companies whose economic statuses are relatively similar, but balance sheets are not. It is a drastic solution to the problem of noncomparability, but it is preferable to allowing other firms to record self-developed goodwill. **[AIMR/FAPC92, p. 31]**

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

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[8] Both the International Accounting Standards Committee and the Accounting Standards Board in the U.K. have proposed five-year amortization periods. That would be an enormous improvement over practice in the United States, but we prefer the current U.K. practice of immediate write-off.

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 5(a)] **[AIMR/FAPC92, p. 31]**

Costs to Create Intangible Assets

We are not enamored of recording self-developed intangible assets unless their values are readily apparent. We consider the cost of creating them to be so often unrelated to their actual value as to be irrelevant in the investment evaluation process. Furthermore, it usually is next to impossible to determine in any sensible or codifiable manner exactly which costs provide future benefit and which do not. For example, even though we would record the contractual amounts of employment agreements, we would not go so far as to capitalize the costs of training and developing human resources. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 32-33]**

We cannot quarrel with capitalization of the costs of intangible assets that are purchased. In that case, the cost is the value of the asset: no heroic or outlandish assumption is required. However, to approach comparability with firms that have created similar intangibles with their own resources, we recommend amortization of the purchased variety over economic lives that we expect will be short. In most cases a purchased intangible will maintain its value only if it is tended and cared for by the type of expenditures that create self-developed ones. A better way of looking at it is that if the purchased intangible is not maintained, it will be exhausted quickly not to be replaced by a self-developed one. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 33]**

We reiterate our strong feeling that goodwill should not be recognized except briefly and only when it is determined by the exchange price for an entire enterprise. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 33]**

The Importance of Cash Flows

The discussion above makes it clear that intangible assets derive their value from the prospects they engender for future cash flows and that it is difficult or impossible in many cases to obtain a sufficiently reasonable measure of their value to place on the balance sheet. Therefore, it is important in extremis for financial reports to disclose clearly the amounts and sources of past cash flows. The ultimate test of the value of an intangible asset is whether or not it contributes to the stream of cash entering the firm. This is exactly the reasoning implicit in FAS 2, "Accounting for Research and Development Costs." Because the expectation of future benefits from research expenditures is so uncertain, their value cannot be recorded in advance. We must wait until they are received in cash. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 33]**

Not only do we have to know the source of cash flows from intangible assets in detail, we also have to know how likely it is that they will continue and at what rate. While the flows continue we need to know what is being done with them. Are they being distributed or reinvested? Are the reinvestments in kind or are they a divergence from past practice? Much of the needed cash flow information requires both disaggregation of historic data and candid management discussion of the future. We speak later in this report at greater length about other aspects of the usefulness of the cash flow statement. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 33]**

Conclusions about Intangible Assets

Our overall conclusion on intangible assets can be summarized as follows. It is an area fraught with difficult conceptual and implementation problems and we do not have a monopolistic position with respect to their solutions. However, we believe that financial reporting can be modified so as at least to recognize more of the economic reality of intangible assets than it does now. We recommend the following: [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 33]**

1. Assets and liabilities should be recognized for the present values of future cash flows when: (a) they are the result of contractual arrangements, and (b) the cost of providing the service does not directly determine its selling price.

2. Goodwill should not be recognized except briefly as it is determined by the exchange price for an entire enterprise because: (a) its determination (except at the rarely-encountered moment of an exchange) is the stuff of financial analysis, not accounting, and (b) its value at that moment is fleeting and has no necessary or causal relationship to its value in the future.

3. Reserve recognition accounting should be reconsidered, supported by adequate prior research.

4. Past cash flows are extremely important and should be reported in terms of: (a) their source, (b) the likelihood of their continuance, and (c) the means to replace them when it becomes necessary. [Also included in 7(b) and 8(c)] **[AIMR/FAPC92, p. 34]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the types of information they use and the adjustments they make to that information to achieve their objectives, investors were specifically asked about goodwill.

Committee/Staff/Observer

What about goodwill? [Also included in 1(b)] **[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 1(b)] **[TI 10/16, p. 34]**

Committee/Staff/Observer
So you differentiate goodwill from other intangibles. [Also included in 1(b) 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 in sections 1(b) 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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[TI 10/16, p. 37]**

Participant I-8
I'd rather see goodwill stay just the way it is. **[TI 10/16, p. 37]**

Participant I-1
Then you can make your own choice, rather than the U.K. situation where it is just gone. **[TI 10/16, p. 37]**

Participant I-8
It's also important historically. If that goodwill wasn't there and the acquisition took place 4 or 5 years ago, it might not be evident to me how that company grew. Whereas with the goodwill you know that there was some purchase. I don't see what's gained by getting rid of goodwill; I think it should stay. **[TI 10/16, p. 37]**

Participant I-11
Conceptually, there is probably no good reason why goodwill should be treated differently from other intangibles. In fact, we look at goodwill differently because we suspect that, in many cases, we are creating an asset because somebody overpaid to buy something. But it's not necessarily so. **[TI 10/16, p. 37-38]**

Participant I-4
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 1(b)] **[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 1(b) 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 1(b)] **[TI 10/16, p. 38]**

Participant I-5
In our discussions today, we seem to be focusing to a very large degree on the income statement as juxtaposed against the balance sheet. One evidence of that was when we talked about goodwill; the notion of amortizing it was construed as a greater penalty than taking it off the balance sheet. I think that if it's not an asset on the balance sheet, it's as much a penalty as being a charge on the income statement. **[TI 10/16, p. 43]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of alternative accounting procedures. During the discussion, several investors commented on goodwill.

Participant I-12
I have a great example. [One company] acquired [another company] and the goodwill went from $500 m to $1 billion or so and is written off over 40 years. The reality is that those are bad loans but somehow those amounts are included in goodwill. This is very confusing. [Also included in 8(b)] **[TI 12/9, p. 47]**

Participant I-8
For example, if you took pooling away, in the real world of economics, it possibly would inhibit the acquisition of a high valuation company by another high valuation company, and I'm not sure that we should do that. [Also included in 8(b)] **[TI 12/9, p. 47]**

Committee/Staff/Observer
Why would it inhibit? [Also included in 8(b)] **[TI 12/9, p. 47]**

Participant I-8
Because they would have to account for it on a purchase basis and they don't want all this goodwill. [Also included in 8(b)] **[TI 12/9, p. 47]**

Participant I-4
That's the case now. There's a number of companies we talked to that are not purchasing because they don't want the goodwill. [Also included in 8(b)] **[TI 12/9, p. 48]**

Committee/Staff/Observer
I've heard companies assert that but I've never heard analysts say we can't see through it. [Also included in 8(b)] **[TI 12/9, p. 48]**

Participant I-4
I think they're saying there's something wrong with the idea of the creation and write-off of goodwill. [Also included in 8(b)] **[TI 12/9, p. 48]**

Participant I-8
They see it as a problem; I don't see it as a problem. [Also in section 8(b)] **[TI 12/9, p. 48]**

Committee/Staff/Observer
What [participant I-8] says is that the transaction won't take place if the opportunity to use pooling is taken away. [Also included in 8(b)] **[TI 12/9, p. 48]**

Participant I-7
Even if goodwill was a taxable item? [Also included in 8(b)] **[TI 12/9, p. 48]**

Participant I-11
That's not going to happen. [Also included in 8(b)] **[TI 12/9, p. 48]**

Participant I-12
In my industry, we immediately substract goodwill from equity. That's a real problem. And the regulators will substract twice the goodwill from the equity. I'd rather see both methods available. [Also included in 8(b)] **[TI 12/9, p. 48]**

Committee/Staff/Observer
Goodwill. If goodwill or some debit is required by a transaction, should it be charged off to the equity section immediately? Last time, [participant I-8] said to leave goodwill as an asset because it leads him to ask other questions. **[TI 12/9, p. 51]**

Participant I-8
You create other distortions when you write goodwill off to equity because it appears that the company's return on equity is phenomenal when in fact it is not. **[TI 12/9, p. 51]**

Participant I-12
Or it appears that the company is going out of business when in fact it's not. That is what I have seen in the banking arena, with the consolidation phase currently going on. The regulators substract the goodwill from the capital account and then the capital account looks pretty bad. **[TI 12/9, p. 51]**

Committee/Staff/Observer
If you follow pooling of interest accounting, don't you get the same high return on equity that you get if you write off the goodwill? [Also included in 8(b)] **[TI 12/9, p. 51]**

Participant I-8
You combine the equity of both entities. [Also included in 8(b)] **[TI 12/9, p. 51]**

Participant I-11
The goodwill arises because you paid more than book value. [Also included in 8(b)] **[TI 12/9, p. 51]**

Committee/Staff/Observer
So you raise equity first and record the goodwill, equity is higher, then you write off the goodwill and come back to something that's closer to the equity you have under pooling of interest accounting. [Also included in 8(b)] **[TI 12/9, p. 52]**

Participant I-8
I don't see it that way. I have an entity with a history of return on equity which I can look at and analyse, and I have the other entity, and they now combine and there might be a difference in combination, but I haven't lost anything in terms of my ability to analyze how profitable those entities were in the past and come to some conclusion about the future. [Also included in 8(b)] **[TI 12/9, p. 52]**

Participant I-7
The 40 years is a different issue. I don't think there is anybody who follows a manufacturing company that does not add back goodwill expense to earnings. **[TI 12/9, p. 52]**

Committee/Staff/Observer
So you agree you do add back amortization. **[TI 12/9, p. 53]**

Participant I-7
Yes. **[TI 12/9, p. 53]**

Participant I-12
As I mentioned before, my problem is that some banks are taking something that is really a loan loss and classify it as goodwill and write it off over 40 years instead of today. It's not a goodwill question so much as a loophole question. On the goodwill issue, I have no problem in my analysis with the way goodwill is accounted for now. I have a problem with when the regulatory authorities treat goodwill differently; then, I need to know what the amount is. And there is plenty of financial companies where you cannot find goodwill on the balance sheet or in the disclosure. **[TI 12/9, p. 53]**

Committee/Staff/Observer
Let me move to the 40 years question. What about the fact that we have a very arbitrary period of 40 years mandated in the standards? **[TI 12/9, p. 53]**

Participant I-6
I think it's too long; I don't know anything that has a 40 year life. **[TI 12/9, p. 53]**

Participant I-5

If goodwill got there because the company is well managed, you should assume it's going to keep growing. Intellectually, if you believe goodwill is an asset, you shouldn't write it off, you should compound it. If you believe goodwill on the balance sheet is a real asset, it should not depreciate, it should appreciate. **[TI 12/9, p. 53]**

Participant I-6
Are you saying that, if it's a true asset, leave it there until it's worthless and then get rid of it? **[TI 12/9, p. 53]**

Participant I-4
The problem is that one views goodwill as a pejorative thing and the fact is, not only is it normally not that, but attempting to write it off over an arbitrary period of 40 years just makes it even worse. I try to add back the number to cash flow and normally think that when I'm doing it, I'm not doing any real justice to it. The fact is that I probably should be adding back much more to the cash flow. **[TI 12/9, p. 54]**

Participant I-5
It's a very easy thing to get goodwill off the balance sheet and the income statement, which is what I would do automatically so I don't really care how it's treated. **[TI 12/9, p. 54]**

Committee/Staff/Observer
You're saying adjust it out of the balance sheet completely? But you just said we ought to be writing it up? **[TI 12/9, p. 54]**

Participant I-5
I said if you believe that it's an asset, then by extension you should believe that it appreciates. I don't believe it should be in the balance sheet, period. **[TI 12/9, p. 54]**

Participant I-6
From my experience, goodwill often turns out to be a line item used to justify for overpaying for companies. Conceptually, I agree with the notion; the reality, from experience, is that it's overpaid. **[TI 12/9, p. 54]**

Participant I-8
I don't agree with that in all cases. For example, in the case of software companies that have no assets, I don't have any problem in taking the amortization as a noncash charge. I don't know that there's anything to be tinkered with from my standpoint. **[TI 12/9, p. 54]**

Participant I-4
I think the way goodwill is accounted for now doesn't really help the situation from an investor's perspective. But I have to admit that I'm hard pressed to think that there is any other easy way to describe it. **[TI 12/9, p. 54]**

Participant I-9
Emotionally, I don't like goodwill and I always substract it out initially. Intellectually, I think you have to leave it in. The reason I don't like it is that it introduces something that I know I'm always wrong about; I'm either understating it or overstating it. If you pay too much for

a company, then you ought to write it off. On the other hand, if you bought the [name deleted] trademark for $1 million, you got a great thing and the earnings from that purchase should offset the goodwill over time. I guess I would compromise and go to a 10-15 year write-off of the goodwill. I think the 40 year part is all wrong. **[TI 12/9, p. 55]**

Participant I-4
But if we buy a business that is well run and we're good managers, goodwill will grow. **[TI 12/9, p. 55]**

Participant I-9
But it should show up in the income statement over time if you made a good deal. **[TI 12/9, p. 55]**

Committee/Staff/Observer
Why are you comfortable with the goodwill that is recognized when you buy [name deleted] but you're not concerned with the fact that the goodwill is not on [their] books today? **[TI 12/9, p. 55]**

Participant I-4
It's in [name deleted] stock price, it's in the valuation. **[TI 12/9, p. 55]**

Participant I-11
The accounting of the balance sheet is based on historical cost and if a company is successful over time, the economic value of the assets tend to increase. If you reprice it at another point in time, then you got to find some way to reprice that difference and we call it goodwill. Then you go forward again with an historically-priced goodwill which may or may not have the same value in the future. It seems to me that a value to it is that it serves as a red flag for analysts to determine whether an acquiring company is making a good investment or is overpaying. **[TI 12/9, p. 55]**

Participant I-12
A rational acquiror would pay an acquiree the net present value of the future cash flows of that business. That net present value may be more or less than stated book value. Theoretically, over time, the revenues would eventually reflect the cash flows embedded in the net present value. From my own perspective, I don't have any problem with the current accounting methodology on goodwill; what I have a problem with is that I want to be sure it's disclosed and available to me for analysis. **[TI 12/9, p. 56]**

Participant I-6
I have a basic problem. For example, [a company] buys a copper mining operation and has a huge goodwill associated with it. Then, [that company], being a British company, writes goodwill off immediately to equity. The company has no control over the selling price of the copper; it may be a great company and have a great name, but the copper that is produced by that company is going to sell at the same price as anybody else's copper. There is no such thing as goodwill with a mine. But the goodwill arises because the acquiree wrote the hole down because it wasn't making money and the market value based on the current commodity

price gave rise to a disparity. Realistically, that mine should have been written back up to its asset value instead of calling it goodwill. **[TI 12/9, p. 56]**

Committee/Staff/Observer
In this example, the company should have debited the "hole in the ground", not goodwill for the value that could be ascribed to it by discounting future cash flows. **[TI 12/9, p. 56]**

Participant I-8
And I have the sense that we don't have a problem with goodwill accounting. I will ask you: what's the problem that you see with goodwill accounting? **[TI 12/9, p. 56]**

From our standpoint, we try to come to some conclusion about the valuation of a security and I would defy you to correlate valuation in the world with stated book value; you can't for a whole bunch of reasons. **[TI 12/9, p. 57]**

Participant I-4
There's a great deal of variation on the importance of goodwill. In a lot of cases, it's kind of irrelevant because we try to determine what values are by capitalizing cash flows. But in a lot of cases, for example for regional banks that are being bought and being value in the equity marketplace, then the establishment of goodwill is a very important thing. And the elimination of goodwill in the balance sheet is also a very important thing as to what the real value, either on an ongoing basis or in a transaction, really is. **[TI 12/9, p. 57]**

Participant I-6
On goodwill, if there was one modification made to it, it would be that I would not allow it to be written off over 5, 10, 15, 20, 40 years; if it's something of value, it should be there. I would see it as a permanent asset like a piece of land until it's really worthless and then written off in total. **[TI 12/9, p. 57]**

Participant I-5
If you reduce what we're doing to the basics, we're looking at what assets these companies have and try to put values on those assets. If you're taking into account how much goodwill is reported on the balance sheet and how much is being amortized, all you're doing is taking into account the decisions of some management at some time on what to pay for another company. If you had those two companies side by side before the purchase, you'd end up without the goodwill on the balance sheet and without the amortization of that goodwill. Is it easier for you to value a company after you know what someone else paid for it? Or is it easier for you to value that company without that added information? If it's the latter, it adds nothing to your analysis. **[TI 12/9, p. 57-58]**

Participant I-4
It also tends to make a buyer who buys a company on a pooling basis to look much more prescient than a person who does it on a purchase basis, which is not true in any sense other than an accounting sense. **[TI 12/9, p. 58]**

Committee/Staff/Observer
If somebody actually does pay for a group of assets, don't you want them to earn a profit on what they paid for it instead of what they were carried at in the books earlier? **[TI 12/9, p. 58]**

Participant I-4
Absolutely. **[TI 12/9, p. 58]**

Participant I-5
What is relevant as an investor, the return on the asset they paid for or the return on the price of the stock you buy? When I'm looking at a company, I'm not looking at a rate of return on their asset base, but rather what I'm paying for that asset base. And what I'm paying has nothing to do with what they paid. **[TI 12/9, p. 58]**

Committee/Staff/Observer
I'm anxiously looking forward to the staff summary of this discussion. How many believe we should leave the amortization period at 40 years? [No one answered.] How many believe we should not write anything off? **[TI 12/9, p. 58]**

Participant I-11
I think I have to say I believe that. **[TI 12/9, p. 58]**

Participant I-8
I agree. **[TI 12/9, p. 59]**

Committee/Staff/Observer
You would do nothing to it until the goodwill is disposed of? **[TI 12/9, p. 59]**

Participant I-8
Right. **[TI 12/9, p. 59]**

Committee/Staff/Observer
How many would write it off over a lesser period than 40 years? [2] **[TI 12/9, p. 59]**

Participant I-4
To the extent that it is equally irrelevant to do that as 40 or 0, I would agree. **[TI 12/9, 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, a comment was made on goodwill.

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 5(c)] **[TC 2/2, p. 26]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of alternative accounting procedures.

Committee/Staff/Observer
[Participant C-15], do you care whether it's a purchase versus a pooling? [Also included in 8(b)] **[TC 2/2, p. 39]**

Participant C-15
Very much so. With purchase accounting, going forward makes our analysis somewhat difficult, because the value of the assets are stepped up and make it a lot more difficult to identify what, if any, goodwill was actually generated. But I think that, in effect, that there is goodwill there, just a matter of how it's recognized. And again, the lack of comparability is an issue of one accounting method chosen versus another. [Also included in 8(b)] **[TC 2/2, p. 39]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of goodwill.

Committee/Staff/Observer
Let us assume that your choice was purchase. The question is, how do we deal with this thing we call goodwill? There has been a lot of criticism about whether or not our current method of amortizing in to ongoing earnings over a period up to 40 years is the right answer. Some have argued that we ought to shorten the period up. Some have argued that it ought not to go through the earnings statement at all, that it ought to be direct charge to equity. There are even those who argue that the way the United States does its goodwill accounting puts its companies at a competitive disadvantage vis-a-vis other people going to the market who have more liberal ways of getting rid of goodwill When you see goodwill, what do you do? Is the method we currently use that smoothes it in over a period of time one a problem and needs a change? And if it needs a change, what would you recommend? Or is it not a problem, or it's a problem but I can handle it and I don't have another answer? **[TC 2/2, p. 42]**

Participant C-5
I wouldn't say it's a tremendous problem, but I will tell you that we automatically adjust for it. I was going to ask the question, is this a broader question than just goodwill; does it include other intangibles as well? **[TC 2/2, p. 43]**

Committee/Staff/Observer
If we could keep it at goodwill for the moment. **[TC 2/2, p. 43]**

Participant C-5
We just make an automatic adjustment, both to the income statement for cash flow analysis purposes, as well as to the balance sheet for leverage and tangible net worth calculations. So we're, in effect, converting to automatic write off. **[TC 2/2, p. 43]**

Committee/Staff/Observer
The whole amount or just portions of it? **[TC 2/2, p. 43]**

Participant C-5
It's 100% write down. And that's the general evaluation criteria that we use. **[TC 2/2, p. 43]**

Participant C-15
I think that we essentially take the same approach. But then I think we're trying to go one step further. Because sometimes when goodwill is generated in an acquisition, there is something tangible that's being generated. Can they earn a return on that investment? That's the general approach that we would take. It's easy to identify, also. It's a separate line item, you can see what the amortization period is and so on. **[TC 2/2, p. 43]**

Participant C-13
We adjust for it, we just write it off. **[TC 2/2, p. 43]**

Participant C-17
Goodwill may have value it's just that we don't know what it is; you look at the cash flows and see how well will this company supports your loan. **[TC 2/2, p. 43]**

Participant C-11
I write it off. There are problems with other intangibles also, for example, mortgage servicing. I'm going to have very different points of view of the value of servicing if a company has an awful lot of that, and a lot of the amortization relates to that. We've had a problem just this last year, there were a lot of companies that had to write off some of these service intangibles. [Also included in 7(b)] **[TC 2/2, p. 43-44]**

Participant C-5
Rather than look at goodwill, in order to make that adjustment, we will typically do a sort of mark to market calculation of any of the multiple type things and then look at our leverage on a business value basis. Because those goodwills invariably suffer particularly if there's been a series of acquisitions and one's a three year old goodwill, one's a four year old goodwill, there's no relativity to market value. There is value in those franchises and half of our analysis goes right down to figure out franchise value. **[TC 2/2, p. 44]**

Committee/Staff/Observer
What if accountants just removed it for you so it was out of your way, and it wasn't there in the first place? Does it matter to you whether it's ever recorded in the first place? Or should it be just excluded from the balance sheet to begin with? **[TC 2/2, p. 44]**

Participant C-11
I think it matters because, for some reason, all of a sudden, you have a reduction in equity. I think you want to know why that happened. **[TC 2/2, p. 44]**

Participant C-15
If it was written off all at once, you wouldn't know what happened; three years from now, you'd say, gee, I got a $4 billion deficit net worth. **[TC 2/2, p. 44]**

Participant C-14
Yes, just wipe it off, I agree. **[TC 2/2, p. 44]**

Participant C-17
I'd be looking at a retained earnings account and say they lost 4 billion bucks. **[TC 2/2, p. 44]**

Committee/Staff/Observer
But it'll be in your changes of capital; you still pick it up on a prior period as a change of capital. **[TC 2/2, p. 44]**

Participant C-15
There is some value to the goodwill; if it's all written off, instead of over a period of time, you may be overstating your earnings going forward. **[TC 2/2, p. 45]**

Participant C-11
I think you have a conceptual problem, too, with a low book value for a company with very strong cash flow earnings. There is analytical content there where the write-off may be pretty harsh. **[TC 2/2, p. 45]**

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 1(c)] **[TC 2/2, p. 45]**

Participant C-17
Your ROA calculation, if you wrote goodwill off would look a whole lot better. **[TC 2/2, p. 45]**

Participant C-14
It seems inconsistent that either you use or you don't. **[TC 2/2, p. 45]**

Participant C-5
But I'm telling you where I don't use it, I take it out of my leverage calculation. I don't adjust my assets. **[TC 2/2, p. 45]**

Participant C-15
That's how you would determine if the goodwill is worth anything or not. **[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 1(c)] **[TC 2/2, p. 46]**

Committee/Staff/Observer
I would say that I'm at the point of extreme confusion about why you would want it in financial statements so you could take it out. What you're saying is you don't always take it out? **[TC 2/2, p. 46]**

Participant C-5
But I'm not too sure that's because we shouldn't take it or just out of carelessness; you can't remember every place to take it out. **[TC 2/2, p. 46]**

Committee/Staff/Observer
Why do you take it out? **[TC 2/2, p. 46]**

Participant C-13
From the point of view of earnings, this is not a cash charge, so you take it out, so that you can establish cash flow. **[TC 2/2, p. 46]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 10—Goodwill Purchased in a Business Combination

Under current purchase accounting, participants seemed to be in agreement that adjustments are usually to eliminate goodwill amortization from earnings analyses. In some cases, net worth or total assets were adjusted to eliminate goodwill. What was not clear was whether participants found value in having good remain in the financial statements instead of eliminating goodwill at the acquisition date and removing need to adjust for it.

Indicate your preferences with 1 being the **most preferred**, 2 the **next preferred** and so on to 3 being the **least preferred**.

___1-3,2-2,3-7 Goodwill should be eliminated when a purchase is first recorded. If eliminated: (check

Participant C-3: Why have goodwill but at the same time, not fair value existing assets?

___9 Goodwill should be charged directly to equity, OR

___1 Goodwill should be charged to earnings in the period of the purchase

___1-5,2-5,3-2 Goodwill should not be eliminated, because: (check as many as are appropriate)

___9 The "excess" paid for a company is useful analytical information that should be preserved

___2 The progress of the buyer's recovery of purchase price is important information

___8 Although it is frequently eliminated in analysis, having the amount in one location is better than burying it in equity

___4 The unrecovered cost should be included in ratios such as return on total assets and return on equity

___1-4,2-5,3-2 Goodwill should not be eliminated, but the maximum amortization period should be greatly reduced to (please check one) _ 5 years, _ 10 years, _ 15 years, _ 20 years.
3 2 3

Participant C-12: Note that goodwill often results from purchasing a like business, and goodwill often brings the basis of purchased assets in line with the accounting for assets acquired in the ordinary course of business (e.g., a bank's bond portfolio).

[PMQC 2/2, p. 18-19]

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 16 - Goodwill Purchased in a Business Combination

Goodwill differs from the other four subjects in this group in that only one method of accounting for purchased goodwill is now accepted in the United States:

- The cost of purchased goodwill—the amount by which the price of the acquired company exceeds the net fair value of its assets and liabilities acquired—is capitalized as an asset at acquisition and amortized to expense over its expected useful life, often 40 years, the maximum permitted by APB Opinion No. 17, *Intangible Assets*

That method has been widely criticized, however, and four other methods have been proposed to replace it. Two of them would differ from present practice only with respect to amortizing the cost of goodwill after acquisition:

- The first method would amortize the cost of goodwill to expense over a period much shorter than 40 years, perhaps as short as 5 to 10 years
- The second would not amortize it over an assumed useful life but would recognize losses from decreases in goodwill when goodwill is lost or its value is impaired

The other two methods would not capitalize the cost of purchased goodwill as an asset:

- The third method would deduct it directly from stockholders' equity at acquisition
- The fourth would deduct it as a loss, separate from operating income, in measuring income of the period of acquisition

In the discussion of goodwill, participants seemed to agree that investors and analysts usually adjust net income to eliminate goodwill amortization. Some also adjust, or know of others who adjust, total assets or equity to eliminate goodwill. What was unclear was whether participants found utility in having goodwill remain in the financial statements instead of being eliminated and, thus, removing the need for investors to adjust for it.

With respect to the various ways of accounting for goodwill purchased in a business combination, please indicate your preference with 1 meaning most preferred, 2 meaning next preferred, and 3 meaning least preferred *(use a number only once)*

	Most preferred	Next preferred	Least preferred
Goodwill should be eliminated at acquisition. If goodwill is eliminated, it should be deducted (please check one)	*3*		*2*
• directly from stockholders' equity at acquisition	*5*		
• as a loss in measuring comprehensive income for the period of acquisition			
• from net income or earnings in the period of the purchase			

	Most preferred	Next preferred	Least preferred
Goodwill should not be eliminated, although it is frequently eliminated in analysis, because (please check as many as are appropriate)	*2*	*2*	*2*
• The "excess" paid for a company is useful analytical information that should be preserved	*3*		
• The progress of the buyer's recovery of purchase price is important information	*1*		
• The unrecovered cost should be included in ratios such as return on total assets and return on equity *Participant I-12*: Gives analysts a choice, depending on their analytical purpose.	*4*		

• To have the amount in one location is better than burying it in stockholders' equity	*2*		
Goodwill should not be eliminated, but the maximum amortization period should be greatly reduced to (please check one)	*1*	*4*	*1*
5 years		*1*	
10 years		*2*	
15 years,			
20 years	*1*	*1*	*1*

[PMQI 12/9 and 1/13, p. 30-32]

[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), 5(b), and 7(b)] **[GOLDMAN, p. 2]**

7(b). Other Intangible Assets

[Context] The AIMR position paper provides a summary of the section (pages 11-20) entitled "The Changing World and Its Implications for Analysis," which describes the effects on financial analysis and financial reporting of three major phenomena:

> The world constantly is changing and everyone must adjust to accommodate those forces over which they have no control. The nature and implications of three major phenomena that are expected to affect financial analysis and analysts are considered here. Those matters also have considerable influence on the views and conclusions expressed later in the paper. . . . [Also included in 16(a), 18(a), and 19] **[AIMR/FAPC92, p. vi]**
>
> Third, the accounting model used today was developed to fit enterprises whose economic activity was primarily in manufacturing or merchandising. Today, services of all types constitute a major portion of economic endeavors. Financial assets play a larger and larger role as more and more funds are saved and invested than ever before. The current accounting model has been challenged on many fronts. Our conclusion is, however, that it is fundamentally sound but there are many ways in which it could be employed more efficaciously than it is today. Much of the remainder of the paper is devoted to describing our suggestions for improvement. [Also included in 19] **[AIMR/FAPC92, p. vi-vii]**

[Context] Those two paragraphs introduce the following excerpts pertaining to the third major phenomenon listed. Excerpts pertaining to the other two phenomena are included primarily in 18(a)-International harmonization of standards and 16(a)-Databases.

> <u>Rise in the Proportion of Economic Activity Conducted by the Service Sector</u>
> Whether we like it or not, manufacturing and mercantile operations have become over time a smaller and smaller segment of the economies of the United States and many other developed nations. Much of the value added by business enterprises in those economies now comes from services: business and personal services, and financial services. These are businesses in which physical assets, plants, inventories, and the like, have little importance. In turn, traditional accounting-based performance measures have also suffer severely reduced usefulness. For example, return on invested capital is not a very meaningful measure in a law firm or accounting firm, or even an investment advisory firm, because so much of the capital is formed from human resources, inherently unmeasurable under current accounting precepts. **[AIMR/FAPC92, p. 17]**
>
> Service firms can be divided into two different categories: financial services and all others. The latter encompasses a variety of activities. Included therein are professional services (legal, accounting, architectural, etc.), business services (telecommunications and cable television, waste removal, etc.), entertainment in all its myriad forms including sports, and educational services provided by a variety of vendors. All of these endeavors have common

implications for financial reporting. First, the value of the service often may have little relation to the cost of providing it. A different perspective would be that certain services are unique or otherwise protected from competition, as in the case of cable television. Conversely, some other services are marketed to a competitive extreme. **[AIMR/FAPC92, p. 17]**

In all of these service companies, traditional measures of profitability, liquidity, productivity, solvency and efficiency have lost some of their usefulness. The share of economic resources represented by plant and other tangible assets has diminished in size and importance, displaced by intangible assets arising from monopoly rights and other singularities, market shares and brand names, contractual and other stable relationships with clientele, and a host of others. In many cases, the future cash flows of the service firm depend on retaining personnel who are trained and competent to provide the services to existing customers and, even more important, to bring new customers to the business. **[AIMR/FAPC92, p. 17]**

The problems in accounting for service-type firms are epitomized by the methods of accounting that apply to computer software firms. FASB Statement 86 sets standards for accounting for the cost of computer software to be sold, leased, or otherwise marketed. Its reasoning is in accord with traditional accounting thought, but its result is to place on the balance sheet as an asset an amount that depicts neither the value of the software nor the total cost of developing it. Software revenue recognition is addressed in AICPA Statement of Position 91-1. It applies accounting for contracts more or less successfully to computer software development, but it gives unsatisfactory answers to the unique problem of a software vendor's continuing obligations to customers after installation. We do not fault either the FASB or the AICPA. They did the best they could in applying the current accounting model to a situation it was not designed to fit. Nor do we believe that the current accounting model should be discarded for one that is radically different. We are at this time merely pointing out the strains on it from applying it to new and different business activities. Our suggestions for change appear later in this report. **[AIMR/FAPC92, p. 17-18]**

[Context] The following brief summary of the topic "Accounting for Intangible Assets," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Current accounting for intangible assets has great potential for confusion. Purchased intangibles are initially recorded at cost and amortized over periods of time that often are arbitrarily determined. Self-developed intangibles are for the most part not recorded. Financial statement comparability between and among enterprises suffers accordingly. Our contemplation of this situation leads us to two major recommendations that we believe will increase comparability. Both recommendations are controversial and should be considered in the light of the full discussion of them in the report. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. viii]**

First, we advocate capitalization of all executory contracts with an initial duration of more than one year. We would include not only leases, but also employment agreements and similar contractual arrangements. Our recommendation does not advocate any change that would weaken the standards governing revenue recognition. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. viii]**

Second, we recommend that purchased goodwill will be written off at the date it is acquired. We believe that it is an important number, but only to depict a value at a particular date, a value that undoubtedly is subject to rapid and sizable change thereafter. We cannot see how its presence on the balance sheet is of use in estimating a firm's future cash flows or gauging its contemporaneous value. Therefore, we recommend banishing goodwill from an enterprise's list of assets, but preserving a record of it by having it show as a separate and distinct reduction of shareholders' equity. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 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.

An earlier part of this report, [pp. 17 and 18, quoted in 7(b)] discusses implications for financial reporting of the rise in the proportion of economic activity attributable to the service sector. One ramification is its exacerbation of the persistent and vexing question of how to account for intangible assets. Service businesses are, with certain notable exceptions such as telecommunications, generally labor intensive. These firms have few tangible assets and in many cases have balance sheets that under conventional accounting show meager or even negative owners' equity. In fact, however, they may possess sizable unrecorded economic resources in the form of anticipated future cash flows. Yet, under traditional accounting methods, the value of those future cash flows is recorded only when: (a) they are acquired in a purchase transaction with an unrelated party, or (b) the anticipated cash finally is received. On the other hand, equity investors and lenders are forced to acknowledge the value of future cash flows in order to make sensible investment and lending decisions in competition with other rational suppliers of capital. Our views on this matter are set forth below. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 29]**

<u>Nature of the Problem</u>
All economic value must ultimately result in cash inflow(s). In fact, it is future cash flows to which both equity investors and lenders look for a return on and return of their investments. Tangible assets offer an additional measure of comfort in that they usually but not always have some value at liquidation even though it may be modest. Furthermore, tangible assets are, without significant exception, acquired in exchange transactions with outsiders and, except for business combinations, are usually acquired individually or in groups of related items. Even when acquired in a basket purchase, it usually is not particularly difficult to obtain competent data to allow their values to be reported separately. Therefore, ordinarily there is little problem in recording at least the initial values of tangible assets. The same is true of intangible assets (patents, franchises, etc.) purchased separately. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 29]**

Major problems arise with accounting for intangible assets that either are self-developed or acquired in a business combination. Other problems emanate from intangibles whose sole value comes from their ability to enhance the cash flows of a going concern. For example, how are analysts sensibly to compare two firms, one of which has developed strong brand names through sizable expenditures none of which has been capitalized (say, the Proctor and Gamble Company), the other of which has grown by purchasing the brand names of others (say, RJR Nabisco)? How are analysts to find useful the financial statements of cable television and other media firms that have significantly negative net worths because they have borrowed against future cash flows and used the proceeds either to cover reported losses or to make payments to stockholders?[7] [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 30]**

Sources of Future Cash Flows

Intangible assets comprise all sorts of contractual, institutional and informal arrangements, all of which are characterized by associated expectations of future cash inflows. Many of these values are attributable to human beings who are talented, well-trained, acculturated, or otherwise able and willing to contribute to the enterprise's economic well-being. Arrangements between the firm and its employees vary. Some, mainly senior managers and others who make unique contributions, serve under individual contracts. Some of those contracts may contain provisions that activate sizable payments at or after the individual's separation from the firm, so-called "golden parachutes" and similar arrangements. At the other end of the scale are collective bargaining agreements with unions and other worker organizations. In between are the ordinary day-to-day, month-to-month continuances of employment and service. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 30]**

Future cash flows may also be attributed to franchises. That term is used in its broadest sense to include not only contractual arrangements, but also other exclusive accesses to customers. A brand name might be said to be a "franchise." For example, one thinks of the position of the Campbell name in canned soup, H.J. Heinz in ketchup or Bayer in aspirin. Another example of an exclusivity is a long-established reputation, such as those carried by the "Big Six" accounting firms, certain major law firms, advertising agencies, actuaries, consultants and a host of other professional services providers. Health care organizations are very likely to have franchises arising from both their reputations and their proximity to patients. A news distributorship in Manhattan, New York City, is worth more than one in Manhattan, Kansas. The examples could go on and on. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 30]**

In many cases expectations of future cash flows may dissipate in the face of competition and are able to continue to flourish only if the enterprise continues to support them with attention and expenditures. Alternatively, exclusive rights may be obtained either under law (patents, copyrights, trademarks, etc.) or by contract. An enterprise may contract for a franchise (in the narrow sense of the word) for human services, for services to be provided by another organization, or for the rights to use real assets (plant and equipment) for limited periods of time. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 30]**

All of the above are intended to be an illustrative but not exhaustive list of the incredible variety of sources of intangible value. All of them illustrate cases of valuable assets that, with two exceptions, are not recorded. One exception is when the asset is purchased in an arms-length exchange transaction. The other exception is for certain lease agreements that meet one

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[7] In 1988, King World Productions, syndicators of the television programs, *Jeopardy*, *Wheel of Fortune* and *Oprah Winfrey*, was reported to have a $30 million negative net worth for exactly that reason. *Forbes*, July 11, 1988, page 83.

of the conditions that qualify them as capital leases. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 31]**

Discovery Values

Some years ago, the SEC initiated an experiment with "reserve recognition accounting" for oil and gas producing firms.* **[*Note added by staff**--While oil and gas reserves are more like inventory--product or raw material still in the ground--than like most intangible assets, they have, as the AIMR report emphasizes, essentially the same recognition and measurement problems as intangible assets.] . It never got beyond the stage of supplemental data and it entailed many practical and conceptual problems. Yet many analysts found that the information it generated, although primitive, was both unique and useful for valuation purposes. Portions of it remain in the disclosure requirements for oil and gas producing activities under FAS 69. AIMR would like to see additional research on reserve recognition accounting as a prelude to a reconsideration of it as a possible replacement for current methods. **[AIMR/FAPC92, p. 32]**

Both the "successful efforts" and "full cost" methods in use today are seriously impaired by their implicit assumption that part or all of the cost of exploration is a decent measure of the value of that which is discovered. Reserve recognition accounting, if feasible, would bring financial reports closer to the economic reality of how wealth is created not only in the oil and gas industry, but also in other types of enterprise in which significant values are created by "discovery." It has the strength of focusing on and reporting how discovery creates wealth and how other activities, such as production, refining, and delivery, enhance it. **[AIMR/FAPC92, p. 32]**

Costs to Create Intangible Assets

We are not enamored of recording self-developed intangible assets unless their values are readily apparent. We consider the cost of creating them to be so often unrelated to their actual value as to be irrelevant in the investment evaluation process. Furthermore, it usually is next to impossible to determine in any sensible or codifiable manner exactly which costs provide future benefit and which do not. For example, even though we would record the contractual amounts of employment agreements, we would not go so far as to capitalize the costs of training and developing human resources. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 32-33]**

We cannot quarrel with capitalization of the costs of intangible assets that are purchased. In that case, the cost is the value of the asset: no heroic or outlandish assumption is required. However, to approach comparability with firms that have created similar intangibles with their own resources, we recommend amortization of the purchased variety over economic lives that we expect will be short. In most cases a purchased intangible will maintain its value only if it is tended and cared for by the type of expenditures that create self-developed ones. A better way of looking at it is that if the purchased intangible is not maintained, it will be exhausted quickly not to be replaced by a self-developed one. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 33]**

We reiterate our strong feeling that goodwill should not be recognized except briefly and only when it is determined by the exchange price for an entire enterprise. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 33]**

<u>The Importance of Cash Flows</u>
The discussion above makes it clear that intangible assets derive their value from the prospects they engender for future cash flows and that it is difficult or impossible in many cases to obtain a sufficiently reasonable measure of their value to place on the balance sheet. Therefore, it is important in extremis for financial reports to disclose clearly the amounts and sources of past cash flows. The ultimate test of the value of an intangible asset is whether or not it contributes to the stream of cash entering the firm. This is exactly the reasoning implicit in FAS 2, "Accounting for Research and Development Costs." Because the expectation of future benefits from research expenditures is so uncertain, their value cannot be recorded in advance. We must wait until they are received in cash. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 33]**

Not only do we have to know the source of cash flows from intangible assets in detail, we also have to know how likely it is that they will continue and at what rate. While the flows continue we need to know what is being done with them. Are they being distributed or reinvested? Are the reinvestments in kind or are they a divergence from past practice? Much of the needed cash flow information requires both disaggregation of historic data and candid management discussion of the future. We speak later in this report at greater length about other aspects of the usefulness of the cash flow statement. [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 33]**

<u>Conclusions about Intangible Assets</u>
Our overall conclusion on intangible assets can be summarized as follows. It is an area fraught with difficult conceptual and implementation problems and we do not have a monopolistic position with respect to their solutions. However, we believe that financial reporting can be modified so as at least to recognize more of the economic reality of intangible assets than it does now. We recommend the following: [Also included in 7(a) and 8(c)] **[AIMR/FAPC92, p. 33]**

1. Assets and liabilities should be recognized for the present values of future cash flows when: (a) they are the result of contractual arrangements, and (b) the cost of providing the service does not directly determine its selling price.

2. Goodwill should not be recognized except briefly as it is determined by the exchange price for an entire enterprise because: (a) its determination (except at the rarely-encountered moment of an exchange) is the stuff of financial analysis, not accounting, and (b) its value at that moment is fleeting and has no necessary or causal relationship to its value in the future.

3. Reserve recognition accounting should be reconsidered, supported by adequate prior research.

4. Past cash flows are extremely important and should be reported in terms of: (a) their source, (b) the likelihood of their continuance, and (c) the means to replace them when it becomes necessary. [Also included in 7(a) and 7(c)] **[AIMR/FAPC92, p. 34]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the types of information they use and the adjustments they make to that information to achieve their objectives, investors were specifically asked about goodwill and other intangible assets.

Participant I-1
What about amortization of things other than goodwill (software, for example)? [Also included in 1(b)] **[TI 10/16, p. 34]**

Participant I-5
Software of course depreciates. Amortization of film inventories counts, it's critical. [Also included in 1(b)] **[TI 10/16, p. 34]**

Committee/Staff/Observer
So you differentiate goodwill from other intangibles. [Also included in 1(b) and 7(a)] **[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 1(b) and 7(a)] **[TI 10/16, p. 34]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of goodwill.

Participant C-11
I write it off. There are problems with other intangibles also, for example, mortgage servicing. I'm going to have very different points of view of the value of servicing if a company has an awful lot of that, and a lot of the amortization relates to that. We've had a problem just this last year, there were a lot of companies that had to write off some of these service intangibles. [Also included in 7(a)] **[TC 2/2, p. 43-44]**

[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), 5(b), and 7(a)] **[GOLDMAN, p. 2]**

7(c). Other

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

> [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), 1(b), and 8(a)] **[GOLDMAN, p. 3]**

8. Alternative Accounting Procedures

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	□

8(a). Procedures Based on Choice, such as Accounting for Inventories and Depreciation

[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 specifically asked about reducing accounting alternatives that are based on free choices.

Committee/Staff/Observer
That's a very good point about accounting alternatives. At a meeting of the subcommittee on current model enhancement in Chicago yesterday, one of the things we talked about was elimination of alternatives. The subcommittee is considering asking the standard setters to eliminate LIFO because of comparability. We also spoke about recommending the elimination of any accounting method other than straight-line, not because it is better, but because we hear from users that they want more comparability. Is eliminating alternatives really what you want? **[TI 10/16, p. 32]**

Participant I-7
Are you suggesting the elimination of LIFO both for reporting and tax purposes? **[TI 10/16, p. 33]**

Committee/Staff/Observer
No. Forget tax purposes. **[TI 10/16, p. 33]**

Participant I-6
As far as eliminating alternatives, I think that would be a major step in the right direction but I would put a big caveat on it. I wouldn't want to see everybody doing this because the needs of one industry may be completely different than 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 a financial services' users would want. Maybe what we have to do is to have specific types of accounting practices for an industry and no alternatives. **[TI 10/16, p. 33]**

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 2(c)] **[TI 10/16, p. 33]**

Participant I-9

The problem with LIFO is not LIFO versus FIFO, it's the year end adjustment. The fact that you can be surprised on that when you settle up at the end of the year. The accounting profession could give us a notice as to what that expected settlement would be. **[TI 10/16, p. 34]**

Participant I-8
It's a function of prices at the end of the year; I'm not sure the accountants could help us on that. **[TI 10/16, p. 34]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of alternative accounting procedures.

Committee/Staff/Observer
The last group of questions are unrelated but involve projects that are now being studied by subcommittees of the Special Committee. The first question . . . relates to alternative accounting procedures. By alternative procedures, we mean accounting methods whose use is essentially at the discretion of management, such as inventory and depreciation methods. Our question is: do you agree with the four paragraphs in the middle of page 14 of the meeting materials? If not, what changes would be needed to make the statement accurate? In effect, what those paragraphs say is that we should eliminate alternative procedures because we hear so much from users that you want comparability. Should we eliminate alternatives so that every company should follow the same basic accounting standards? **[TI 12/9, p. 41]**

Participant I-6
In the pure sense of it, I would argue for one set of books, tax and public reporting, but that's not the question. I think there should be standardized methods in inventory and depreciation, but I would not go so far as to say that everybody should use the same methods; I would standardize along industry guidelines. But more standardization would be better. **[TI 12/9, p. 41]**

Participant I-8
For example, if you prescribe FIFO for everybody, forgetting the requirements of analysts for more comparability, in an inflationary period, you would have some gross overstatements of earnings. So you're not reflecting the true economics of the organization. I don't think that does anybody any good. **[TI 12/9, p. 41]**

Participant I-7
LIFO would negatively impact earnings in a period of rising costs. **[TI 12/9, p. 42]**

Participant I-8
Right and that's a better reflection of the real economics of the business. **[TI 12/9, p. 42]**

Participant I-7

Because of the differences in the companies that we all follow, and even within the same industry, I don't necessarily require my companies to standardize. What I want is disclosure; then I feel it gives me a level-playing field. **[TI 12/9, p. 42]**

Participant I-12
I'll vote for that one. There are a lot of situations; for example, there is trade date and settlement date accounting for securities firms. The differences can be enormous. But if I know which method a company is using, I can make my adjustments my way. I'm all for disclosure but I don't think we ought to lock all American companies into the same principles because it might not be appropriate in a number of cases. **[TI 12/9, p. 42]**

Participant I-4
I don't think it's really correct of us to presume that we can set standards that everyone has to follow. I don't have any problems with alternative uses as long as the methods used are clearly enunciated. **[TI 12/9, p. 42]**

Committee/Staff/Observer
[Participant I-12] let's go back to your example of trade versus settlement date. Assuming you have two firms in basically the same business, and one uses one method and the other the other method, how is that useful to the investor when they look at those financial statements? Wouldn't it be better if the company did the adjusting for you and adopted one method? Wouldn't you get a more accurate result if everyone used settlement date, for example? **[TI 12/9, p. 42]**

Participant I-12
The difference between the two I believe is 5 days of float. It's a one-time difference. Is there a need for making major adjustments? Probably not, other than to recognize the existence of the difference. There's a material difference on the date you adopt the method or make the change, but not material differences afterwards. What I'm saying is that there's plenty of room for differential accounting if we know the methods that are used. **[TI 12/9, p. 43]**

Committee/Staff/Observer
To follow on with that question. In situations where the amounts are not easily identifiable in the financial statements, for example in the case of depreciation, how would you go about adjusting the information? Where do you get the information? Said in a different way, if disclosure is an acceptable substitute to mandating one-size-fits-all, then how would you get the information to true up different entities to the same basis? **[TI 12/9, p. 43]**

Participant I-7
My companies will generally give in the annual report the LIFO accrual provision, so I can tell from that source. **[TI 12/9, p. 43]**

Committee/Staff/Observer
But, for example, maybe in the case of the successful effort versus full cost, when there is not a discrete number in the footnote or the balance sheet, how would you go about doing that, or how do you go about that, or do you? **[TI 12/9, p. 43]**

Participant I-7
If it were significant, I would have to ask the company. **[TI 12/9, p. 43]**

Participant I-8
I have a lot of companies where that difference is the deferred tax item, for example in the case of depreciation accounting; if it's not that, then you have to ask. **[TI 12/9, p. 43]**

Participant I-6
I disagree. I have asked some of my companies time and time again what's the difference between successful efforts and full costs and it's huge and all of a sudden they have a huge write-off. For inventory accounting, it's pretty simple but you get beyond that and it's not that simple. **[TI 12/9, p. 44]**

Participant I-7
In my industries, I tend to find that a discussion about FIFO or LIFO or straight-line or sum-of-the-digits never comes up with my clients until there is a problem. For years, I had a major company in the industry telling every analyst about how conservative their accounting was and they had consistent profit problems and they were never rewarded for it. **[TI 12/9, p. 44]**

Participant I-9
On the inventory side, I don't think there's much of a problem; there aren't that many accounting standards used and they are well understood. What you worry about in the inventory is the age of the inventory, whether it's obsolete or not. The problem on the depreciation is not straight-line versus sum-of-the-digits, it's that I don't have any confidence on the useful life selected for depreciation. Whichever method you use is less relevant than having the right number of years to depreciate. **[TI 12/9, p. 44]**

Committee/Staff/Observer
[Committee/staff/observer] asked a very key question. For inventory, you get the difference between methods in the disclosure, but in depreciation, you don't get the difference between an accelerated method and a straight-line method. I think that working backwards from the deferred tax footnote is an oversimplistic answer and may not really be true. So the question [committee/staff/observer] is asking is do you even care or how do you go about doing it? Is it something that is not important to you? **[TI 12/9, p. 44]**

Participant I-6
It's important to me in the natural resources industry. **[TI 12/9, p. 44]**

Participant I-4
I think to some degree it's a question that can't be answered with disclosure and it highlights the idea that accounting presentation is only one part of the work that we do. Accounting information highlights the questions that we need to ask to management. I don't know if this could properly be shown in a disclosure item. **[TI 12/9, p. 45]**

Participant I-7

I don't want all the companies to fit in the same box. I want full disclosure so that I can make my mind up. I'll say it again; until there is an earnings problem, no one asks about the differences between LIFO and FIFO. **[TI 12/9, p. 45]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of alternative accounting procedures.

Committee/Staff/Observer
Can we turn to page 21 [of the meeting materials]? Looking at the first part of the question 11, it walks you down through a question and an answer thing that we want to impose on each one of these topics. If it is a problem, what do you do to solve it?. That is, do you make a change, yourself? Is it a problem that you think needs to be limited to only one answer that's good for everyone? Or is it an answer that has to be imposed on individual industries? And if the answer is no, it's a problem but I don't want to see any change. Then does that mean that it's not a problem that's not surmountable in anyway in user analysis? We'll try this on the first one. Alternative procedures. Inventories can be FIFO or LIFO. And depreciation can use a variety of different methods. And you can get very complex accounting that goes around from, say, full cost to successful efforts or in the investment business trade date versus settlement date. In some cases, the footnotes have the information that if you wanted to recast you could, either directly because the footnotes tell you the alternative number. Or indirectly, because the footnotes basically allow you to extrapolate back to what the number probably is or close to it but in other cases there's no clue to unravel what it looked like if we used the other approach. So where there's a choice of accounting methods, should we eliminate that choice and prescribe one method? **[TC 2/2, p. 35-36]**

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 2(c)] **[TC 2/2, p. 36]**

Committee/Staff/Observer
When you encounter a company that is using a choice, do you do something? **[TC 2/2, p. 36]**

Participant C-14
We won't recast our entire financial statements. We kind of adjust the numbers so that they're more comparable to others in the industry that may be using a different method. Because a lot of the analysis is getting into profitability, core profitability, and once you're using the same principles you can see the competitive position. **[TC 2/2, p. 37]**

Participant C-7
Looking at the segment that we service, lot of these decisions are driven by the tax consequences. A typical owner wants to maximize after-tax cash flow. That's the reason for the selection of LIFO or FIFO or accelerated depreciation method. I don't see in our analysis that we run into any surmountable difficulties in dealing with these. **[TC 2/2, p. 37]**

Committee/Staff/Observer
So are you saying that living with the status quo in a multi-choice world is fine with you? **[TC 2/2, p. 37]**

Participant C-7
In our environment, for the type of customers we're servicing, yes. **[TC 2/2, p. 37]**

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 2(c)] **[TC 2/2, p. 37]**

Committee/Staff/Observer
My understanding is that the analysts might be more interested in what capital expenditure is going to be and what repairs and maintenance might be, as opposed to what is the precise difference between the straight line and the sum of the digits or a straight line and some other accelerated method. **[TC 2/2, p. 37]**

Participant C-5
Yes. **[TC 2/2, p. 37]**

Participant C-17
Public companies want to show profits. If I took the same company, private and public, looked at the bottom line, private guy, he's going to show as little as he can. Because he's not reporting to a shareholder. I understand that, whereas a public company is going to try to balance the two. So this doesn't trouble me in terms of having to make those adjustments. I think the world's so complex that I think to try and mandate a vanilla standard is impractical. **[TC 2/2, p. 37-38]**

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 2(c)] **[TC 2/2, p. 38]**

Committee/Staff/Observer
Within the same company? [Also included in 2(c)] **[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 2(c)] **[TC 2/2, p. 38]**

Participant C-11
A very important point to make is that the methods which are being used should be disclosed. That is, the importance of it is that the analyst, not the accountant, but the analyst is then in the position to know what adjustments to make. For example, if somebody is aggressively depreciating, or definitely under depreciating, then you can at least think about the industry that you're dealing with. Think about the fact as to what if somebody has got an impaired asset future because they didn't properly depreciate or vice versa. They're, in effect, hiding all kinds of wonderful cash flow. Of course, the cash flow statement deals with that; the important thing is that you know what's going on, which isn't always easy. **[TC 2/2, p. 38]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 7—Inventory Methods

With respect to alternative inventory accounting methods, FIFO or LIFO, please indicate your preference with **1** meaning **most preferred**, **2** meaning **next preferred**, and so on to **5** meaning **least preferred** (use a number only once).

___1-2,2-2,3-2,4-2,5-2 No change in accounting is needed; companies should continue to have free choice of which inventory method to use as long as each disc loses which method it uses

___1-3,2-3,3-4,4-0,5-0 Companies should have a choice of method, but if LIFO is chosen, supplemental disclosure on a FIFO basis should be provided

Participant C-18: These are not alternatives.

___1-2,2-4,3-4,4-0,5-0 Companies should have a choice of method, but if FIFO is chosen, supplemental disclosure on a LIFO basis should be provided

Participant C-18: These are not alternatives.

___1-2,2-0,3-0,4-1,5-7 Only FIFO should be permitted because (check all that you believe are appropriate)

- ___2 FIFO better reflects the way inventories are managed and thus better reflects inventory costs and gross profits on sales of inventory.
- ___4 LIFO can artificially boost profits through decreasing units on hand at year-end.
- ___2 Need for comparability outweighs whatever conceptual merits LIFO may have.
- ___1 Other. Please describe

Participant C-18: None of these reasons are appropriate - limiting to FIFO only would distort F/S - very bad idea.

Participant C-2: Generally, (but not always) offers a better approximation of inventory value for collateral margins on the balance sheet.

___1-2,2-1,3-1,4-6,5-0 Only LIFO should be permitted because (check all that you believe are appropriate)

___4 LIFO dampens the effects of inflation on gross profits

Participant C-2: Is becoming far less critical.

___4 LIFO can be used for tax purposes only if used for financial reporting as well
___3 Need for comparability outweighs whatever conceptual merits FIFO may have
___ Other. Please describe

Participant C-18: Again, choice is key to reflecting differences (one situation to another). But this method is better (if only one choice) then FIFO.

Participant C-2: Make estimation of values other than LOCOM (book) a little more difficult (or a lot more difficult in some cases!)
[PMQC 2/2, p. 14-15]

QUESTION 8—Depreciation Methods

With respect to alternative depreciation methods—

Please indicate your preference with **1** meaning **most preferred**, **2** meaning **next preferred**, and **3** meaning **least preferred** (use a number only once).

___1-6,2-5,3-2 No change in accounting is needed; companies should continue to have free choice of which depreciation method to use as long as each discloses which method it uses

___1-4,2-7,3-2 Companies should have a choice of method, but if other than straight-line depreciation is chosen, supplemental disclosure on a straight-line basis should be provided

___1-3,2-2,3-6 Only one depreciation method should be permitted, and that method should be

___2 Straight-line depreciation, because (please check as many as are appropriate)

___1 Need for comparability outweighs whatever conceptual merits accelerated depreciation may have

___1 Most companies already use straight-line depreciation, and there is little or no reason for a small minority to be different

___ Other. Please describe

Participant C-17: I cannot assign a rating as long as I know the effect of depreciation on cash flows, I am indifferent to the one and three options.

Participant C-15: Different methods are appropriate for different industries.

___5 Accelerated depreciation, because (please check as many as are appropriate)

___4 Accelerated depreciation better reflects the way plant and equipment assets wear out

___4 Accelerated depreciation is widely used for tax purposes, and its use in financial statements would decrease the differences between reported net income and taxable income

___ Other. Please explain

Participant C-17: Same as above.

Participant C-14: Management decisions on asset purchases/sales reflect the tax incentives.

___ Other method. Please specify

Participant C-17: Same as above.

___3 Either straight line or accelerated depreciation. *Only one depreciation method should be permitted* because of reason(s) below (please check as many as are appropriate), but *I am indifferent about which method is chosen*

Participant C-2: Can work with either.

___3 Need for comparability outweighs whatever conceptual issues may be involved

___1 Other. Please describe

Participant C-17: Same as above.
[PMQC 2/2, p. 16-17]

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 13 - Inventory Methods

With respect to alternative inventory accounting methods—
- FIFO, the first-in, first-out method (including for our purposes its equivalent for fungible inventories that are physically mixed—the weighted-average method), which attributes the oldest costs to cost of goods sold and the most recent costs to inventory on hand
- LIFO, the last-in, first-out method, which attributes the most recent costs to cost of goods sold and the oldest costs to inventory on hand—

8(a). Procedures Based on Choice, such as Accounting for Inventories and Depreciation--Page 11

Please indicate your preference with 1 meaning most preferred, 2 meaning next preferred, and so on to 5 meaning least preferred *(use a number only once)*

	1	2	3	4	5
No change in accounting is needed; companies should continue to have free choice of which inventory method to use as long as each discloses which method it uses	*3*		*1*	*1*	*2*
Companies should have a choice of method, but if LIFO is chosen, supplemental disclosure on a FIFO basis should be provided	*1*	*5*	*1*		
Companies should have a choice of method, but if FIFO is chosen, supplemental disclosure on a LIFO basis should be provided	*1*	*2*	*3*	*1*	
Only FIFO should be permitted because (check all that you believe are appropriate)	*2*			*2*	*2*

• FIFO better reflects the way inventories are managed and thus better reflects inventory costs and gross profits on sales of inventory	*2*
• LIFO can artificially boost profits through decreasing units on hand at year-end	*1*
• Need for comparability outweighs whatever conceptual merits LIFO may have	*1*
• Other. Please describe *Participant I-11*: LIFO has no conceptual merits- it is purely a tax device. It also offers opportunities for easy manipulation by varying period-ending inventory when prices are high.	*1*

	1	2	3	4	5
Only LIFO should be permitted because (check all that you believe are appropriate)	*1*		*3*	*1*	*2*

• LIFO dampens the effects of inflation on gross profits	*2*
• LIFO can be used for tax purposes only if used for financial reporting as well	*2*
• Need for comparability outweighs whatever conceptual merits FIFO may have	*2*
• Other. Please describe *Participant I-9*: I prefer LIFO generally but in some industries it does not make much difference whether LIFO or FIFO is used. *Participant I-12*: Another choice: must report using same method as internal management (a twist on current practice)	

[PMQI 12/9 and 1/13, p. 25-27]

QUESTION 14 – Depreciation Methods

With respect to alternative depreciation methods—

- straight-line depreciation methods, which report the same amount of depreciation for each year, each unit of output, or each hour of use constituting the useful life of an asset
- accelerated depreciation methods, such as sum-of-the-years'-digits or double-declining-balance, which report a declining amount of depreciation as assets get older—

8(a). Procedures Based on Choice, such as Accounting for Inventories and Depreciation–Page 13

Please indicate your preference with 1 meaning most preferred, 2 meaning next preferred, and 3 meaning least preferred *(use a number only once)*

	1	2	3
No change in accounting is needed; companies should continue to have free choice of which depreciation method to use as long as each discloses which method it uses *Participant I-12*: Information on classes of assets and/or average lives would be helpful. Especially for data processing and high tech items.	*2*	*1*	*4*
Companies should have a choice of method, but if other than straight-line depreciation is chosen, supplemental disclosure on a straight-line basis should be provided	*3*	*4*	
Only one depreciation method should be permitted, and that method should be *(check one of the following boxes: straight-line depreciation, accelerating depreciation, other method, or either straight-line or accelerating depreciation)*	*2*	*2*	*3*
Straight-line depreciation, because (please check as many as are appropriate)	*1*		
• Need for comparability outweighs whatever conceptual merits accelerated depreciation may have	*1*		
• Most companies already use straight-line depreciation, and there is little or no reason for a small minority to be different			
• Other. Please describe			

	1	2	3
Accelerated depreciation, because (please check as many as are appropriate)	*4*		
• Need for comparability outweighs whatever conceptual merits straight-line depreciation may have	*2*		
• Accelerated depreciation better reflects the way plant and equipment assets wear out	*3*		
• Accelerated depreciation is widely used for tax purposes, and its use in financial statements would decrease the differences between reported net income and taxable income	*3*		
• Other. Please explain			
Other method. Please specify and explain why it should be adopted			
Either straight line or accelerated depreciation. Only one depreciation method should be permitted because of reason(s) below (please check as many as are appropriate), but I am indifferent about which method is chosen			
• Need for comparability outweighs whatever conceptual issues may be involved			
• Other. Please describe			

[PMQI 12/9 and 1/13, p. 22-26]

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

> [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), 1(b), and 7(c)] **[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) 4, 5(a), 5(c), 6, 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, 5(a), 6, 9, and 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 1(b) and 15] **[BETRIOU, p. 3]**

8(b). Procedures Based on Criteria, excluding Accounting for Leases, such as Accounting for Business Combinations

Business Activities That Do Not Fit a Manufacturing/Mercantile Accounting Model
The traditional accounting model was developed originally to fit mercantile firms by matching to sales revenue the costs of products sold together with the other periodic costs of running the business. It also was grounded in the concept of the business entity. It was modified, through the aegis of cost accounting to include manufacturing activities. That modification was less than perfect and resulted oftentimes in the need for additional information to be generated outside the accounting system for use in decision making and control. But, for external reporting purposes the fit was considered adequate and is being followed more or less faithfully today even though much business activity takes place for which the traditional accounting model is inadequate. We do not think that it should be discarded or replaced, but we believe that it is in need of some major modifications, as we specify in more detail later. [Also included in 8(d)] **[AIMR/FAPC92, p. 16]**

Changes in business ownership
Merger and acquisition activity ebbs and flows with economic cycles, but each pinnacle seems higher than the last. Many people believe that existing values can be realized only when a transaction takes place, a major premise of accounting as practiced today. But this leads to many financial statement anomalies. For example, when Firm A is purchased by Firm B, it is the assets and liabilities of Firm A that are recorded at their fair value, not those of Firm B. That is because those values are considered to have been validated by a transaction, even though the transaction was for a single price for the entire firm and cannot be a reliable measure of the specific value of any of its components. One could then argue that whatever techniques are used to place values on the individual assets and liabilities of Firm A could be used just as reliably to restate the assets and liabilities of Firm B. If not, then we perhaps ought not to apply them to Firm A. **[AIMR/FAPC92, p. 16]**

An even more difficult situation arises when Firm B acquires less than total ownership of Firm A. Under current practice, only the proportionate share of Firm A's assets and liabilities owned by Firm B are revalued, but all of Firm A's assets and liabilities, partially revalued, partially not, are consolidated with those of Firm B, none of whose assets and liabilities have been revalued. What a mélange! The result is a combination of historic and current values that only a mystic could sort out with precision. **[AIMR/FAPC92, p. 16]**

The rise of highly leveraged transactions (HLT) and the concomitant issuance of high risk securities raises additional problems. Questions arise as to the extent to which values that obviously exist, because lenders and others have invested in them, should be recognized in the financial statements. In many cases we see accounting that differs because of the form of the underlying transaction, not its substance. Concurrently, we see differences in substance that are not reflected in the accounting. . . .**[AIMR/FAPC92, p. 16]**

The matters discussed in this section currently have been and are addressed in several FASB Discussion Memoranda (DMs). We commend the Board for confronting them. Completion of the FASB's work on this subject is needed to eliminate the remarkable conceptual inconsistency in accounting in these areas and its exacerbation by intense business acquisition and combination activity. [Also included in 8(d)] **[AIMR/FAPC92, p. 17]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing the types of information they use to achieve their objectives, investors made comments on accounting alternatives that are based on set criteria.

Participant I-8
When I first came into the business in the early 60s, you could drive a truck through the differences in earnings depending on which of the GAAP was employed by a company. Over the years, there has been a tightening up so there is much less variability in terms of management's choice of GAAP. However, one thing I object to that has been done recently, is the introduction of software capitalization after we have disallowed the capitalization of R&D in general. This introduces subjectivity in GAAP and I would go back the other way and eliminate the possibility of capitalizing software costs. **[TI 10/16, p. 32]**

It's not only comparability but also the subjectivity involved in the capitalization of software costs that is concerning. **[TI 10/16, p. 33]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of alternative accounting procedures.

Committee/Staff/Observer
With respect to business combinations, we believe that having two accepted methods of accounting for business combinations is confusing and spoils intercompany comparisons. It is argued that the pooling of interests method should be eliminated because it rarely, if ever, reflects the transaction that occurred and gives results that cannot be compared with those of the purchase method. Do you agree or disagree? **[TI 12/9, p. 45]**

Participant I-7
I'd rather it go the opposite way. What I find is that the purchase method allows the purchaser to distort dramatically in some cases the operating results of the acquired enterprise. For example, one company is acquiring another and there's a $90 million FASB 106 adjustment, which is spelled out in the notes to the annual report and it is also mentioned that it will not be material. You ask the company why it is not going to be material and they answer that this cost is going to be included in the goodwill arising on the purchase and amortized over 40 years. **[TI 12/9, p. 46]**

Participant I-8
I think purchase accounting, if what we're trying to do is project future earnings, allows for more finagling than pooling. **[TI 12/9, p. 46]**

Participant I-11
I'm not sure I would say it allows for more but both methods allow for finagling. Somehow pooling got to be pegged the bad boy and purchase accounting got to be the fair-haired boy and I never quite understood why. Purchase accounting makes intercompany comparisons a little better, pooling makes interperiod comparisons more understandable. I think we ought to have both of them. **[TI 12/9, p. 46]**

Committee/Staff/Observer
You say you would like both of them but not necessarily in the same circumstances? **[TI 12/9, p. 46]**

Participant I-11
Not in the same circumstances, right. I'm saying I don't have any problem with having two methods. **[TI 12/9, p. 46]**

Participant I-7
I would agree with [participant I-11] and I would say that what we're not getting is full disclosure. **[TI 12/9, p. 46]**

Participant I-8
You don't get full disclosure on purchase accounting. There's an awful lot in purchase accounting that we don't see disclosed. For example, there was a case where inventories were written off at the time of acquisition, then subsequently sold and shown as operating earnings in subsequent periods. **[TI 12/9, p. 47]**

Participant I-7
How about closing down plants and taking associated costs with that as part of the acquisition? **[TI 12/9, p. 47]**

Participant I-12
I have a great example. [One company] acquired [another company] and the goodwill went from $500 m to $1 billion or so and is written off over 40 years. The reality is that those are bad loans but somehow those amounts are included in goodwill. This is very confusing. [Also included in 7(a)] **[TI 12/9, p. 47]**

Participant I-8
For example, if you took pooling away, in the real world of economics, it possibly would inhibit the acquisition of a high valuation company by another high valuation company, and I'm not sure that we should do that. [Also included in 7(a)] **[TI 12/9, p. 47]**

Committee/Staff/Observer
Why would it inhibit? [Also included in 7(a)] **[TI 12/9, p. 47]**

Participant I-8

Because they would have to account for it on a purchase basis and they don't want all this goodwill. [Also included in 7(a)] **[TI 12/9, p. 47]**

Participant I-4
That's the case now. There's a number of companies we talked to that are not purchasing because they don't want the goodwill. [Also included in 7(a)] **[TI 12/9, p. 48]**

Committee/Staff/Observer
I've heard companies assert that but I've never heard analysts say we can't see through it. [Also included in 7(a)] **[TI 12/9, p. 48]**

Participant I-4
I think they're saying there's something wrong with the idea of the creation and write-off of goodwill. [Also included in 7(a)] **[TI 12/9, p. 48]**

Participant I-8
They see it as a problem; I don't see it as a problem. [Also included in 7(a)] **[TI 12/9, p. 48]**

Committee/Staff/Observer
What [participant I-8] says is that the transaction won't take place if the opportunity to use pooling is taken away. [Also included in 7(a)] **[TI 12/9, p. 48]**

Participant I-7
Even if goodwill was a taxable item? [Also included in 7(a)] **[TI 12/9, p. 48]**

Participant I-11
That's not going to happen. [Also included in 7(a)] **[TI 12/9, p. 48]**

Participant I-12
In my industry, we immediately substract goodwill from equity. That's a real problem. And the regulators will substract twice the goodwill from the equity. I'd rather see both methods available. [Also included in 7(a)] **[TI 12/9, p. 48]**

Committee/Staff/Observer
If you follow pooling of interest accounting, don't you get the same high return on equity that you get if you write off the goodwill? [Also included in 7(a)] **[TI 12/9, p. 51]**

Participant I-8
You combine the equity of both entities. [Also included in 7(a)] **[TI 12/9, p. 51]**

Participant I-11
The goodwill arises because you paid more than book value. [Also included in 7(a)] **[TI 12/9, p. 51]**

Committee/Staff/Observer

So you raise equity first and record the goodwill, equity is higher, then you write off the goodwill and come back to something that's closer to the equity you have under pooling of interest accounting. [Also included in 7(a)] **[TI 12/9, p. 52]**

Participant I-8
I don't see it that way. I have an entity with a history of return on equity which I can look at and analyze, and I have the other entity, and they now combine and there might be a difference in combination, but I haven't lost anything in terms of my ability to analyze how profitable those entities were in the past and come to some conclusion about the future. [Also included in 7(a)] **[TI 12/9, p. 52]**

Committee/Staff/Observer
Am I hearing that basically the current accounting principles for acquisitions are working but perhaps there is some abuse in the application of these principles? Or am I hearing that we need to write a clean piece of paper on acquisition accounting? **[TI 12/9, p. 59]**

Participant I-8
It's basically working with the exception that I don't think there is enough disclosure under purchase accounting about how the assets are written up or down and the reserves created at the date of acquisition and the utilization of those reserves in subsequent periods. **[TI 12/9, p. 59]**

Participant I-11
I believe that the present systems (purchase accounting and pooling) each has its weaknesses and each has been abused, but I think they work pretty well. **[TI 12/9, p. 59]**

[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 on business combinations.

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 5(a)] **[TI 1/13, p. 28]**

[Context] Meeting of the Investor Discussion Group on March 17, 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 business combinations.

Participant I-16
I would agree with numbers 3 (unconsolidated entities) and 12 (interim reporting). I would add numbers 5 (business combination practices), 8 (disclosure of measurement uncertainties), and 16 (impairment); for number 16, I'm more concerned about long-lived assets than receivables. For number 8, I'm concerned with getting more explanations about where things are and come from. Business combination practices is an area where we don't understand how companies account for acquisitions; they don't explain that and you can't follow it. [Also included in 9 and 15] **[TI 3/17, p. 66]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of alternative accounting procedures.

Committee/Staff/Observer
Next issue: business combinations. There are two choices here but they're really aren't choices. A given business combination in a certain form will get purchase or pooling accounting. Now, the form can be changed and sometimes in a fairly nominal way, and you change which accounting you get. But in any one circumstance, only one is supposedly applicable. But the results, of course, are dramatically different. **[TC 2/2, p. 39]**

Participant C-5
I think that definitely should be addressed. I'm not sure which way it should go. I don't like the purchase method because it distorts future earnings. I mean, you may still be recognizing something on the profits because of the big charges they took off from for the next five years on their transaction. It creates distortions, not only for the one period but for five, seven periods just between one of the large acquisition and another. **[TC 2/2, p. 39]**

Committee/Staff/Observer
[Participant C-15] do you care whether it's a purchase versus a pooling? [Also included in 7(a)] **[TC 2/2, p. 39]**

Participant C-15
Very much so. With purchase accounting, going forward makes our analysis somewhat difficult, because the value of the assets are stepped up and make it a lot more difficult to identify what, if any, goodwill was actually generated. But I think that, in effect, that there is goodwill there, just a matter of how it's recognized. And again, the lack of comparability is an issue of one accounting method chosen versus another. [Also included in 7(a)] **[TC 2/2, p. 39]**

Committee/Staff/Observer
So would you suggest we ought to land on one versus the other method and say it's applicable to all transactions? **[TC 2/2, p. 39]**

Participant C-15

I think it would make life somewhat easier. For some of the other types of differences in accounting, LIFO versus FIFO, you could get a pretty good idea of what the differences are with additional disclosures. I think it's a lot more difficult under business combination methods. **[TC 2/2, p. 39]**

Participant C-5
At the very bottom end of the scale, single purpose entity small transactions, I don't mind purchase accounting. But when you do a [Company A/Company B] merger, you know that's not a purchase. The distortions you get out of purchase accounting are so significant. **[TC 2/2, p. 40]**

Committee/Staff/Observer
What's causing your concern with purchase accounting? Is it the actual valuation? Or is it a combination of mixed asset values and some are stepped up and some aren't? What is behind your concern? **[TC 2/2, p. 40]**

Participant C-5
It's actually the other way around. You stepped down the asset values in order to get nice recoveries for the next five years on that loan portfolio. You'll never take a charge for it. I mean, [Company B], that portfolio one minute the accountant said it was worth this much, the next minute, [Company A] said it's worth this much. I can just imagine $2 billion in profits finding their way back through the income statement for the next two years that the pooling method would not have created. There clearly is a distortion. If there's any community of things that are analyzed in a data base format, it's financial institutions because of the regulatory standards of uniform reporting; a year and a half from now, people will still forget about the [Company A] distortions and the multiples will be the same as any other company out there. **[TC 2/2, p. 40]**

Participant C-5
When dealing with operations of that size and scope, the merger of those two retains the basic concept of historical cost accounting without having to revalue every asset in today's transaction price. **[TC 2/2, p. 40]**

Committee/Staff/Observer
Did I sense you were questioning how they applied the fair value concepts in purchase accounting? **[TC 2/2, p. 40]**

Participant C-5
Well, I did that as well. But I think the pooling is going to still have been a much more appropriate reflection of that. **[TC 2/2, p. 41]**

Participant C-13
The distortion would have occurred if the assets had been carried by [Company B] at fair value. **[TC 2/2, p. 41]**

Participant C-17
I think that the general level of discomfort exists because the way it's approached very often is really in the sense of financial engineering more than anything else. And the criticisms that have been held forth on purchase method accounting should be coming from the other direction, that the pooling method gave companies the ability to really buy off multiples. So it's an area that whichever way you go, the typical analyst looks at it with a great deal of skepticism. And I, for one, feel that a lot of what's done is no more than trying to manage the numbers or the process to their own benefit. I'm not comfortable with it. **[TC 2/2, p. 41]**

Participant C-7
In June 1992, we completed an acquisition that was accounted for as a purchase. In July 1992, we made an acquisition that was accounted for as pooling of interest. Looking at the substance of those transactions, it was the same result. Both transactions bought financial institutions in our Pittsburgh market. It seems that the issue of what financial engineering was almost what can we negotiate. **[TC 2/2, p. 41]**

Committee/Staff/Observer
Would you prefer to have one method that works in all cases? That is, pick the "P" word you like, but that's the method we're going to use in all circumstances. Is that the solution to the problem that you see? **[TC 2/2, p. 41]**

Participant C-11
I'll just make a small footnote about the pooling debate of the '60's and '70's. And that is that, in my mind, this sounds very simple but one of the problems was, I think, that people reported earnings per share on refigured basis. And showed, by doing so, significant growth rates. **[TC 2/2, p. 41]**

Participant C-17
What it did was it buried the premium that you were paying. **[TC 2/2, p. 42]**

Participant C-11
Right. And the very simple thing that you could have been done at the time was to have the company also report historical or originally reported earnings per share. So you could see from a company that did a pooling every year, that the stockholder wasn't coming out ahead on a per-share basis. There were very bad abuses then but it was partly because there was, in my mind, inadequate reporting, inadequate in the way it put pressure from analysts to have the companies do a better job. **[TC 2/2, p. 42]**

Participant C-4
If you went to mark to market accounting. [Also included in 4] **[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 4] **[TC 2/2, p. 42]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 9 Purchase and Pooling of Interests Methods of Accounting for Business Combinations

Regarding the alternative methods of business combinations, purchase versus pooling, participants seemed particularly concerned with the lack of comparability and need for greater disclosure associated with the purchase method of accounting. Please consider the following:

Indicate your preferences with **1** being the **most preferred**, **2** the **next preferred** and so on to **4** being the **least preferred.**

___1-3,2-1,3-4,4-5 Only the POOLING method of business combination accounting should be permitted.

Participant C-2: Doesn't pooling have limited applicability: i.e., stock issuance?

___1-2,2-1,3-1,4-8 Only the PURCHASE method of business combination accounting should be permitted.

___1-2,2-8,3-2,4-0 The PURCHASE method could be permitted as an alternative to POOLING, if (mark as appropriate):

___13 The disclosure about purchase accounting adjustments were expanded to permit easier comparisons of before-and-after purchase earnings.

___11 Purchase accounting rules were changed to prevent purchase accounting abuses that allow post-purchase earnings to be inflated because of conservative purchase accounting allocations.

___1-6,2-1,3-5,4-0 PURCHASE and POOLING should continue to be alternatives, but the rules for when they apply (check only one):

___1 Should be changed to reduce the number of POOLINGS.

___3 Should be changed to reduce the number of PURCHASES.

___11 Should be changed to eliminate form tests and, instead, use tests of economic substance.

Participant C-2: Is this possible? Were not the form tests trying to get at economics substance?
[PMQC 2/2, 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 alternative accounting procedures.

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 4, 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 15 - Purchase and Pooling of Interests Methods of Accounting for Business Combinations

With respect to alternative methods of accounting for business combinations—

- purchase method, which reports a business combination as a transaction in which a company issues stock, and/or pays cash, and/or incurs debt to acquire the assets and liabilities of another company at a total price bargained on the basis of the fair values of the assets, liabilities, and shares of stock that change hands
- pooling of interests method, which reports a business combination involving only stock as a transaction between the two groups of stockholders to which neither company was a party, and combining the assets, liabilities, and equities of the two companies at their book values before the transaction—

8(b). Procedures Based on Criteria, excluding Accounting for Leases, such as Accounting for Business Combinations–Page 11

Please indicate your preference with 1 meaning most preferred, 2 meaning next preferred, and 3 meaning least preferred *(use a number only once)*

	1	2	3
Only the pooling of interest method should be permitted because (check all that you believe are appropriate)	*2*	*1*	*2*

• Need for comparability outweighs whatever conceptual merits the purchase method may have	*2*
• 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	*4*
• 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	*3*
• Other. Please describe	

8(b). Procedures Based on Criteria, excluding Accounting for Leases, such as Accounting for Business Combinations—Page 12

	1	2	3
Only the purchase method should be permitted because (check all that you believe are appropriate)		*3*	*2*

• Need for comparability outweighs whatever conceptual merits the pooling of interest method may have	
• The purchase method reports the economic reality that most, if not all, business combinations are acquisitions of one company by another	*2*
• 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	*2*
• Other. Please describe	

8(b). Procedures Based on Criteria, excluding Accounting for Leases, such as Accounting for Business Combinations--Page 13

	1	2	3
No change in accounting is needed; 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 (check all that you think are appropriate)	*5*	*2*	
• 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	*6*		
• Rules for applying the purchase method are 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	*6*		
• Rules for applying the pooling of interests method are 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	*6*		
• Other. Please describe *Participant I-12*: Prevent (or disclose necessary information) abuses that inflate the growth rate of net income- at least for the first few years after an acquisition- when using purchase method.	*1*		

[PMQI 12/9 and 1/13, p. 27-30]

8(c). Accounting for Leases and Other "Executory" Contracts

[Context] The following brief summary of the topic "Accounting for Intangible Assets," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

> Current accounting for intangible assets has great potential for confusion. Purchased intangibles are initially recorded at cost and amortized over periods of time that often are arbitrarily determined. Self-developed intangibles are for the most part not recorded. Financial statement comparability between and among enterprises suffers accordingly. Our contemplation of this situation leads us to two major recommendations that we believe will increase comparability. Both recommendations are controversial and should be considered in the light of the full discussion of them in the report. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. viii]**
>
> First, we advocate capitalization of all executory contracts with an initial duration of more than one year. We would include not only leases, but also employment agreements and similar contractual arrangements. Our recommendation does not advocate any change that would weaken the standards governing revenue recognition. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. viii]**
>
> Second, we recommend that purchased goodwill will be written off at the date it is acquired. We believe that it is an important number, but only to depict a value at a particular date, a value that undoubtedly is subject to rapid and sizable change thereafter. We cannot see how its presence on the balance sheet is of use in estimating a firm's future cash flows or gauging its contemporaneous value. Therefore, we recommend banishing goodwill from an enterprise's list of assets, but preserving a record of it by having it show as a separate and distinct reduction of shareholders' equity. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 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.

> An earlier part of this report, [pp. 17 and 18, quoted in 7(b)] discusses implications for financial reporting of the rise in the proportion of economic activity attributable to the service sector. One ramification is its exacerbation of the persistent and vexing question of how to account for intangible assets. Service businesses are, with certain notable exceptions such as telecommunications, generally labor intensive. These firms have few tangible assets and in many cases have balance sheets that under conventional accounting show meager or even negative owners' equity. In fact, however, they may possess sizable unrecorded economic resources in the form of anticipated future cash flows. Yet, under traditional accounting methods, the value of those future cash flows is recorded only when: (a) they are acquired in a purchase transaction with an unrelated party, or (b) the anticipated cash finally is received. On the other hand, equity investors and lenders are forced to acknowledge the value of future cash flows in order to make sensible investment and lending decisions in competition with other

rational suppliers of capital. Our views on this matter are set forth below. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 29]**

Nature of the Problem

All economic value must ultimately result in cash inflow(s). In fact, it is future cash flows to which both equity investors and lenders look for a return on and return of their investments. Tangible assets offer an additional measure of comfort in that they usually but not always have some value at liquidation even though it may be modest. Furthermore, tangible assets are, without significant exception, acquired in exchange transactions with outsiders and, except for business combinations, are usually acquired individually or in groups of related items. Even when acquired in a basket purchase, it usually is not particularly difficult to obtain competent data to allow their values to be reported separately. Therefore, ordinarily there is little problem in recording at least the initial values of tangible assets. The same is true of intangible assets (patents, franchises, etc.) purchased separately. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 29]**

Major problems arise with accounting for intangible assets that either are self-developed or acquired in a business combination. Other problems emanate from intangibles whose sole value comes from their ability to enhance the cash flows of a going concern. For example, how are analysts sensibly to compare two firms, one of which has developed strong brand names through sizable expenditures none of which has been capitalized (say, the Proctor and Gamble Company), the other of which has grown by purchasing the brand names of others (say, RJR Nabisco)? How are analysts to find useful the financial statements of cable television and other media firms that have significantly negative net worths because they have borrowed against future cash flows and used the proceeds either to cover reported losses or to make payments to stockholders?[7] [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 30]**

Sources of Future Cash Flows

Intangible assets comprise all sorts of contractual, institutional and informal arrangements, all of which are characterized by associated expectations of future cash inflows. Many of these values are attributable to human beings who are talented, well-trained, acculturated, or otherwise able and willing to contribute to the enterprise's economic well-being. Arrangements between the firm and its employees vary. Some, mainly senior managers and others who make unique contributions, serve under individual contracts. Some of those contracts may contain provisions that activate sizable payments at or after the individual's separation from the firm, so-called "golden parachutes" and similar arrangements. At the other end of the scale are collective bargaining agreements with unions and other worker organizations. In between are the ordinary day-to-day, month-to-month continuances of employment and service. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 30]**

Future cash flows may also be attributed to franchises. That term is used in its broadest sense to include not only contractual arrangements, but also other exclusive accesses to customers. A brand name might be said to be a "franchise." For example, one thinks of the position of the Campbell name in canned soup, H.J. Heinz in ketchup or Bayer in aspirin. Anther

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[7] In 1988, King World Productions, syndicators of the television programs, *Jeopardy*, *Wheel of Fortune* and *Oprah Winfrey*, was reported to have a $30 million negative net worth for exactly that reason. *Forbes*, July 11, 1988, page 83.

example of an exclusivity is a long-established reputation, such as those carried by the "Big Six" accounting firms, certain major law firms, advertising agencies, actuaries, consultants and a host of other professional services providers. Health care organizations are very likely to have franchises arising from both their reputations and their proximity to patients. A news distributorship in Manhattan, New York City, is worth more than one in Manhattan, Kansas. The examples could go on and on. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 30]**

In many cases expectations of future cash flows may dissipate in the face of competition and are able to continue to flourish only if the enterprise continues to support them with attention and expenditures. Alternatively, exclusive rights may be obtained either under law (patents, copyrights, trademarks, etc.) or by contract. An enterprise may contract for a franchise (in the narrow sense of the word) for human services, for services to be provided by another organization, or for the rights to use real assets (plant and equipment) for limited periods of time. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 30]**

All of the above are intended to be an illustrative but not exhaustive list of the incredible variety of sources of intangible value. All of them illustrate cases of valuable assets that, with two exceptions, are not recorded. One exception is when the asset is purchased in an arms-length exchange transaction. The other exception is for certain lease agreements that meet one of the conditions that qualify them as capital leases. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 31]**

<u>Contractual Arrangements</u>

Contractual arrangements are quite opposite from goodwill. We refer here to what are commonly called executory contracts, those awaiting performance by both parties[*]. With the exception of capital leases, executory contracts are not recorded in financial statements and are disclosed only when they are material and out of the ordinary course of business. We have observed the machinations that often accompany the classification of lease agreements. We also are overwhelmed by the excessive volume of extremely detailed accounting definitions, procedures and rules designed to foil such intrigues. **[AIMR/FAPC92, p. 31-32]**

We suggest a standard that would be far simpler but broader in its application. We would require capitalization of all executory contracts with an initial term in excess of one year. That would eliminate many of the problems attendant on lease accounting. More importantly, it would place on the balance sheet at least some of the quite real intangible assets that do not now appear. For example, in the case of King World Productions (see footnote 7) it would

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[*] **[*Note added by staff--*Executory* is a legal term meaning yet to be executed or performed; incomplete. Its opposite is *executed*, meaning already done or performed; completed. Because neither of the following is an "executed" contract, both are "executory" contracts:**

- **A contract in which the parties have exchanged promises but neither has performed on its promise--for example, a lease at inception**
- **A contract in which only one party has performed on its promise--for example, the seller has delivered goods but the buyer has not yet paid for them.**

Both, however, can be described more precisely than as "executory" contracts. The first is a "fully (or wholly) executory" contract, while the second is a partially executory" or "partially executed" contract. Accountants' habitual use of the unmodified term, picked up by analysts in this report, is potentially confusing or misleading because it fails to distinguish between fully and partially executory contracts.]

allow recording as assets contractual rights with television stations with a corresponding liability to produce programming in the future.[9] We see that as not significantly different from capital lease accounting. We believe that employment contracts with executives and key employees also should be capitalized, even if performance cannot be compelled. If the employee resigns, the remaining equal amounts of intangible asset and obligation to pay wages would be removed from the balance sheet. If the employee is discharged, the remaining intangible asset would be a loss to the extent that the enterprise continued to be liable either for future compensation to the employee or for a settlement. **[AIMR/FAPC92, p. 32]**

Costs to Create Intangible Assets

We are not enamored of recording self-developed intangible assets unless their values are readily apparent. We consider the cost of creating them to be so often unrelated to their actual value as to be irrelevant in the investment evaluation process. Furthermore, it usually is next to impossible to determine in any sensible or codifiable manner exactly which costs provide future benefit and which do not. For example, even though we would record the contractual amounts of employment agreements, we would not go so far as to capitalize the costs of training and developing human resources. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 32-33]**

We cannot quarrel with capitalization of the costs of intangible assets that are purchased. In that case, the cost is the value of the asset: no heroic or outlandish assumption is required. However, to approach comparability with firms that have created similar intangibles with their own resources, we recommend amortization of the purchased variety over economic lives that we expect will be short. In most cases a purchased intangible will maintain its value only if it is tended and cared for by the type of expenditures that create self-developed ones. A better way of looking at it is that if the purchased intangible is not maintained, it will be exhausted quickly not to be replaced by a self-developed one. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 33]**

We reiterate our strong feeling that goodwill should not be recognized except briefly and only when it is determined by the exchange price for an entire enterprise. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 33]**

The Importance of Cash Flows

The discussion above makes it clear that intangible assets derive their value from the prospects they engender for future cash flows and that it is difficult or impossible in many cases to obtain a sufficiently reasonable measure of their value to place on the balance sheet. Therefore, it is important in extremis for financial reports to disclose clearly the amounts and sources of past cash flows. The ultimate test of the value of an intangible asset is whether or not it contributes to the stream of cash entering the firm. This is exactly the reasoning implicit in FAS 2, "Accounting for Research and Development Costs." Because the expectation of future benefits from research expenditures is so uncertain, their value cannot be recorded in

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[9] We do not anticipate that revenue recognition would be affected by the recognition of the rights and obligations under executory contracts. In fact, it should be. The standards for the *measurement* of revenue ought to be independent of the standards for the *recognition* of assets and liabilities.

advance. We must wait until they are received in cash. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 33]**

Not only do we have to know the source of cash flows from intangible assets in detail, we also have to know how likely it is that they will continue and at what rate. While the flows continue we need to know what is being done with them. Are they being distributed or reinvested? Are the reinvestments in kind or are they a divergence from past practice? Much of the needed cash flow information requires both disaggregation of historic data and candid management discussion of the future. We speak later in this report at greater length about other aspects of the usefulness of the cash flow statement. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 33]**

<u>Conclusions about Intangible Assets</u>
Our overall conclusion on intangible assets can be summarized as follows. It is an area fraught with difficult conceptual and implementation problems and we do not have a monopolistic position with respect to their solutions. However, we believe that financial reporting can be modified so as at least to recognize more of the economic reality of intangible assets than it does now. We recommend the following: [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 33]**

1. Assets and liabilities should be recognized for the present values of future cash flows when: (a) they are the result of contractual arrangements, and (b) the cost of providing the service does not directly determine its selling price.

2. Goodwill should not be recognized except briefly as it is determined by the exchange price for an entire enterprise because: (a) its determination (except at the rarely-encountered moment of an exchange) is the stuff of financial analysis, not accounting, and (b) its value at that moment is fleeting and has no necessary or causal relationship to its value in the future.

3. Reserve recognition accounting should be reconsidered, supported by adequate prior research.

4. Past cash flows are extremely important and should be reported in terms of: (a) their source, (b) the likelihood of their continuance, and (c) the means to replace them when it becomes necessary. [Also included in 7(a) and 7(b)] **[AIMR/FAPC92, p. 34]**

[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, 5(a), 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), 4, 5(a), 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>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 1(d)] **[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 1(d)] **[AIMR/FAPC92, p. 62]**

[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 specifically about current accounting alternatives for leases.

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 **1(b)**] **[TI 10/16, p. 38]**

Participant I-9
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 **1(b)**] **[TI 10/16, p. 39]**

Participant I-1
If you have one accounting treatment for all leases, you need to get more disclosures as to the nature of the leases. For example, in terms of termination; a 5 year lease is not a 5 year lease

for everyone, you might have more flexibility to get out of the lease obligation in some circumstances. **[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 **1(b)**] **[TI 10/16, p. 41-42]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of alternative accounting procedures. Comments were made on accounting for leases.

Committee/Staff/Observer
Changing the topic to leases, would you favor a change in practice to require capitalization of all leases, assuming that they're leases with a term extending beyond the balance sheet date? **[TI 12/9, p. 49]**

Participant I-11
I don't. I have the same position on that than I do on business combination accounting. In fact, I'm not totally comfortable with capitalized leases since it has created a couple of artificial items on the balance sheet. **[TI 12/9, p. 49]**

Committee/Staff/Observer
What kind of artificial items? **[TI 12/9, p. 49]**

Participant I-11
The imputed value of the lease is an artificial value (using an implicit interest rate). **[TI 12/9, p. 49]**

Committee/Staff/Observer
We are lead to believe that in some industries, like in retailing and the airplane industry, analysts regularly convert operating leases into capital leases as part of their analysis. Would that be correct? **[TI 12/9, p. 49]**

Participant I-9
I would like to see one common accounting method for leases. What bothers me with capital leases is when, for example, you have a company that enters into a $10 million lease and then it appears as debt of $7.5 million on the balance sheet. Intellectually, I can understand that but it still bothers me. The problem is that the number is not relevant if you're in a distressed situation because a company can get out of a lease obligation in some circumstances. **[TI 12/9, p. 49]**

Participant I-6
I think that just full disclosure of the obligation under the lease agreement is more meaningful than the way the leases are accounted for on the balance sheet. **[TI 12/9, p. 49]**

Participant I-4
I agree with [participant I-6] it's more important to have full disclosure than to account for the lease in a specific way. **[TI 12/9, p. 50]**

Participant I-12
From a lessor's point of view, I always felt uneasy about the accounting for residual values; not enough information is provided about them. **[TI 12/9, p. 50]**

Participant I-6
Leases are a perfect example of things you could get rid of in the balance sheet and just put in the footnotes. This is one area where you could simplify. **[TI 12/9, p. 50]**

Committee/Staff/Observer
Would you suggest that we have every lease as an operating lease coupled with footnote disclosure of the terms of the lease and the cash flows? Is that what you mean by simplify? **[TI 12/9, p. 50]**

Participant I-6
Yes. **[TI 12/9, p. 50]**

Committee/Staff/Observer
You're saying: "capitalize no leases"? **[TI 12/9, p. 50]**

Participant I-6
Correct. **[TI 12/9, p. 50]**

Participant I-4
I would definitely prefer to have all leases treated as operating leases, with disclosure, rather than capitalized leases. **[TI 12/9, p. 50]**

Participant I-9
I have to say that capitalized leases are the answer in retailing; you can't have a retail balance sheet without capitalized leases because the alternative is a mortgage. **[TI 12/9, p. 51]**

[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 reference to accounting for leases.

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 notional 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 4] **[TI 1/13, p. 7]**

[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 accounting for leases.

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 1(b)] **[TC 12/8, p. 45]**

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 1(b)] **[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 1(b)] **[TC 12/8, p. 47]**

Committee/Staff/Observer
So you're capitalizing the operating leases? [Also included in 1(b)] **[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 1(b)] **[TC 12/8, p. 47]**

[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
Again, here's two choices. A lease can be structured to be an operating or a capital lease. It is a form test. Which means that a transaction can be structured a certain way, get a certain kind of accounting. The question is whether or not accounting should ordain one method of accounting for all leases? **[TC 2/2, p. 46]**

Participant C-17
If I'm an equipment lessor and you kill operating leases, you kill me. **[TC 2/2, p. 46]**

Participant C-15
I'll use the airline industry as an example. Companies like [names deleted], provide leases to airlines; those are for one year or two years, three years, for a limited period of time. And that's all that the obligation for the airline is. As opposed to a financing lease which is a 25 year obligation. To have the same accounting for both would seem to me to not do justice to the flexibility that the company would have from entering into operating lease. **[TC 2/2, p. 46-47]**

Participant C-17
The issue for me with operating leases is: what is the company's real liability, because, for instance, in an equipment lease, if it's a five year term and they go into liquidation or bankruptcy, what ever else, I can prove that it's a new lease. That lessee is responsible to me for the full value of my rents. And that's a real liability he has. If it's a real estate lease, the liability may be for a year or I think it goes up to three years. So when I'm trying to evaluate how leveraged that company is, with debts that are not showing up on the balance sheet, I don't feel that I have a very good handle on how to do it. The only thing I can do is sit there and say, I don't know what it is on the present value basis; I just sum everything and say, well, potentially he's going to have to pay $12 billion and maybe not. **[TC 2/2, p. 46]**

Participant C-5
Maybe this is not a question of two choices but that the form test is not the right form test. **[TC 2/2, p. 47]**

Committee/Staff/Observer
What would be the right criteria? **[TC 2/2, p. 47]**

Participant C-5
Twenty-five year lease I'm pretty clear, it's a capital lease regardless of what. Five year is less clear. **[TC 2/2, p. 47]**

Participant C-15
That's probably right in the middle of gray; five years. **[TC 2/2, p. 47]**

Committee/Staff/Observer
Well, five year with four renewal options? **[TC 2/2, p. 47]**

Participant C-5

Yes. **[TC 2/2, p. 47]**

Committee/Staff/Observer
Going back to what you do as users, facing this multi-headed lease monster. I think [participant C-17] is saying that he has got a problem and he's not able to completely solve it with simply writing it off the balance sheet against the equity section like we've done with goodwill. **[TC 2/2, p. 48]**

Participant C-17
I'm saying that the footnote liability may not, in fact, be the true legal liability that that particular company has because of the adjustments that can occur. **[TC 2/2, p. 48]**

Participant C-5
He's talking default liability. I'm worried about fixed charge coverage and future periods and so forth. I'm not worried about an acceleration in all cases. **[TC 2/2, p. 48]**

Committee/Staff/Observer
So do you make that adjustment? **[TC 2/2, p. 48]**

Participant C-5
Yes, we add them back and treat them as capital. **[TC 2/2, p. 48]**

Committee/Staff/Observer
Where's your cut when you look at an operating leases? **[TC 2/2, p. 48]**

Participant C-5
I think it's industry convention. There are certain industries you automatically adjust back for, and other industries you don't. **[TC 2/2, p. 48]**

Participant C-11
I tend to try to capitalize, put it on the balance sheet. But I admittedly don't know all the nuances of these two year, three year things. **[TC 2/2, p. 48]**

Participant C-15
I think the way I'm trying to deal with a short-term lease, is to capitalize it, doing some kind of sensitivity analysis as to options to roll it over. But if you assume a going concern for an airline, for example, they'll need those airplanes, and those are really like fixed charges almost. So we capitalize them and see what impact they have on their capital structure. **[TC 2/2, p. 48]**

Committee/Staff/Observer
I'm not convinced that I've heard a clear indication of whether or not that means that the accounting should all be the same way. **[TC 2/2, p. 49]**

Participant C-17
From my own opinion, that's true. Companies enter into financial arrangements for more than just accounting; there are true economic benefits. **[TC 2/2, p. 49]**

Participant C-5
I would agree with that. I'm not so sure the current test finds the right break. **[TC 2/2, p. 49]**

Participant C-4
As long as we get the information we can make the adjustments and analyze the effects. **[TC 2/2, p. 49]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group.

QUESTION 11—Lease Accounting Methods

With respect to alternative methods of accounting for leases—

Please indicate your preference with **1** meaning **most preferred**, **2** meaning **next preferred**, and so on to **5** meaning **least preferred** (use a number only once).

___1-6,2-1,3-3,4-3,5-1 All leases other than month-to-month leases and leases whose terms do not extend past the balance sheet date should be capitalized

___1-1,2-0,3-2,4-4,5-5 All leases should be accounted for as operating leases

___1-4,2-5,3-3,4-1,5-0 Some leases should be considered operating leases, while others should be capitalized. Please indicate whether you **S—Strongly Agree, A—Agree,** or **D—Disagree** with each of the following:

SA-2,A-4,D-4___ Operating leases should be the exception, not the rule

SA-2,A-6,D-3___ Some leases should be operating leases, while others should be capitalized. The difference depends principally on the lease period

SA-0,A-4,D-7___ Some leases should be operating leases, while others should be capitalized. The difference depends principally on the type of asset being leased

SA-2,A-1,D-2___ Some leases should be operating leases, while others should be capitalized. The difference depends principally on (please describe)

Participant C-17: Economic risk-who bears it as an indication of true ownership.

Participant C-15: Economically, intention to renew.

Participant C-18: Whether or not the lease substantially uses up economic life of asset leased.

Participant C-2: Whether ownership transfers at end of period.

Participant C-4: The materiality of the current lease payments - base on percent of current liabilities.

___1-3,2-7,3-0,4-2 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. Please indicate whether you **S—Strongly Agree, A—Agree,** or **D—Disagree** with each of the following:

SA-5,A-5,D-2___ Lease obligations need separate disclosure by type of asset (e.g., real estate, major operating assets, tangible personal property, etc.)

SA-3,A-7,D-2___ Lease obligations need disclosure of maturities (i.e., grouping separately leases with short, medium, and long terms)

SA-2,A-5,D-5___ Lease obligations need to be distinguished 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

SA-1 ___ Other. Please describe

Participant C-14: PV of operating leases could substitute for capitalization.

___1-0,2-0,3-4,4-2,5-6 Lease accounting should eliminate operating lease alternatives, at least for some assets, but the determination should be specified on an industry-by-industry basis

[PMQC 2/2, p. 19-21]

[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 accounting for leases.

Committee/Staff/Observer
I have a specific question on 13 which is accounting for financial instruments including off balance-sheet-financing. Those who ranked that in the top three, did you include off-balance-sheet leases or weren't you thinking about it? [Also included in 15 and 19] **[TC 3/11, p. 74]**

Participant C-11
Not in the same context. For different reasons, I think this classifies as off-balance-sheet. I think they're very different risks. [Also included in 15 and 19] **[TC 3/11, p. 74]**

Committee/Staff/Observer
So would you also encompass in 13 changes in accounting or information about off-balance-sheet leases? [Also included in 15 and 19] **[TC 3/11, p. 75]**

Participant C-11
I think it should be on balance sheet myself but ...[Also included in 15 and 19] **[TC 3/11, p. 75]**

Committee/Staff/Observer
But the reason is not because of the qualitative questions you had with respect to everything else that's off-balance-sheet? [Also included in 15 and 19] **[TC 3/11, p. 75]**

Participant C-17
I don't think anybody's mystified about what an operating lease is all about. I think there's a great deal more esoteric around the hedging situation. I'm not certain that the management itself always has the sophistication or focus that they ought to. [Also included in 15 and 19] **[TC 3/11, p. 75]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 17 - Lease Accounting Methods

With respect to alternative methods of accounting for leases—
- capital lease method, which results in the recognition of an asset and a liability by the lessee
- operating lease method, which does not result in the recognition of an asset and a liability by the lessee, but rather by the recognition of a rental expense as the cash payments accrue on the lease—

Please indicate your preference with 1 meaning most preferred, 2 meaning next preferred, and so on to 5 meaning least preferred *(use a number only once)*

	1	2	3	4	5
All leases other than month-to-month leases and leases whose terms do not extend past the balance sheet date should be capitalized	*1*	*1*		*1*	*1*
All leases should be accounted for as operating leases	2				2

	1	2	3	4	5
Some leases should be considered operating leases, while others should be capitalized. Please indicate whether you S—Strongly Agree, A—Agree, or D—Disagree with each of the following:			*2*	*1*	

	Strongly agree	Agree	Disagree
Operating leases should be the exception, not the rule	*1*	*1*	*2*
Some leases should be operating leases, while others should be capitalized. The difference depends principally on the lease period		*1*	*2*
Some leases should be operating leases, while others should be capitalized. The difference depends principally on the industry and/or the type of asset being leased			*3*
Some leases should be operating leases, while others should be capitalized. The difference depends principally on the amount of lease payments relative to the value of the leased asset			*3*
Some leases should be operating leases, while others should be capitalized. The difference depends principally on (please describe)			*2*

	1	2	3	4	5
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. Please indicate whether you S—Strongly Agree, A—Agree, or D—Disagree with each of the following:		*1*	*1*	*1*	

	Strongly agree	Agree	Disagree
• Lease obligations need separate disclosure by type of asset (e.g., real estate, major operating assets, tangible personal property, etc.)	*2*	*3*	
• Lease obligations need disclosure of maturities (i.e., grouping separately leases with short, medium, and long terms)	*2*	*3*	
• Lease obligations need to be distinguished 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	*3*	*1*	*1*
• Other. Please describe *Participant I-11*: Disclosure by type of asset with maturity information also disclosed by type of asset.			

	1	2	3	4	5
Lease accounting should eliminate operating lease alternatives, at least for some assets, but the determination should be specified on an industry-by-industry basis	*2*	*1*		*1*	*1*

Participant I-12: Lease accounting is difficult: the key issue to me is the "capital" aspect. In essence, companies are renting capital equipment for a whole variety of reasons (obsolescence, financial and tax incentives, etc.) What about the lessors? Theie leasing assets are generally viewed as "loan" equivalents. If lessees are capitalizing leases, it would seem that lessors should treat leases comparably. Since I'm not as familiar with the details of lease accounting, it seems like there are a number of issues that need more discussion

[PMQI 12/9 and 1/13, p. 32-34]

8(d). Other

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]**

- RMA supports comprehensive interperiod allocation of income taxes for all temporary book/tax differences. Because of its emphasis on future cash flow effects, RMA prefers the liability method to the deferred method to account for the tax effect of revenues and expenses that appear on the income statement currently, but which will have tax consequences in the future. **[RMA90, p. 8]**

  Future tax benefits should not be recognized until they are assured beyond a reasonable doubt. In the case of benefits arising from operating loss carryforwards, that assurance is not obtained until such time as the benefits are realized via applying the carryforward to actual taxable income. A company's ability to realize future tax benefits from temporary differences is dependent on so many factors that its determination is better left to the auditors of individual companies than to the standards-setting process. **[RMA90, p. 8]**

- Accounting for pensions and other forms of postemployment benefits should adhere to the methodology employed in FAS 87 for defined benefit pension plans of private sector enterprises. Specifically: **[RMA90, p. 8]**

  a. The cost of providing benefits should be accrued over the working life of the employees covered by the plan(s). **[RMA90, p. 8]**

  b. A single actuarial method should be used in determining plan liabilities and periodic cost. **[RMA90, p. 8]**

  c. There should be internal consistency in the valuation of plan assets and liabilities. **[RMA90, p. 8]**

  d. Standard methodology should be used systematically to recognize:
     1) investment gains and losses
     2) underwriting gains and losses
     3) changes in actuarial assumptions
     4) changes in the provisions of the plan **[RMA90, p. 8]**

  e. Adequate disclosure, includes but is not limited to, the major components of periodic cost, the current funding status of the plan including the balances of individual unrecognized amounts, changes arising from business acquisitions or dispositions, and the effect of transition amounts not associated with the current period. **[RMA90, p. 8]**

There appears to be little reason to require inclusion on the balance sheet of a "minimum liability" computed on a different actuarial method or basis than the one used to determine periodic benefit cost. **[RMA90, p. 8]**

Business Activities That Do Not Fit a Manufacturing/Mercantile Accounting Model

The traditional accounting model was developed originally to fit mercantile firms by matching to sales revenue the costs of products sold together with the other periodic costs of running the business. It also was grounded in the concept of the business entity. It was modified, through the aegis of cost accounting to include manufacturing activities. That modification was less than perfect and resulted oftentimes in the need for additional information to be generated outside the accounting system for use in decision making and control. But, for external reporting purposes the fit was considered adequate and is being followed more or less faithfully today even though much business activity takes place for which the traditional accounting model is inadequate. We do not think that it should be discarded or replaced, but we believe that it is in need of some major modifications, as we specify in more detail later. . . . [Also included in 8(b)] **[AIMR/FAPC92, p. 16]**

In addition to the problem of when to recognize new values at the time of business combinations, we have the old one of when to derecognize values that no longer exist. It is difficult today to find a major company that has not during the three most recent years had at least one major writedown of asset values under the rubric of "restructuring charge" or some similar appellation. More times than not these come as fourth quarter "surprises" to financial analysts. Not only do we need standards that make asset impairment writedowns more predictable, we also find it peculiar that many accountants deem writedowns to be good because they are "conservative" whereas writeups are not. It seems to us that whatever criteria are applied to determine writedowns would be every bit as verifiable and useful if also applied to writeups. **[AIMR/FAPC92, p. 16-17]**

The matters discussed in this section currently have been and are addressed in several FASB Discussion Memoranda (DMs). We commend the Board for confronting them. Completion of the FASB's work on this subject is needed to eliminate the remarkable conceptual inconsistency in accounting in these areas and its exacerbation by intense business acquisition and combination activity. [Also included in 8(b)] **[AIMR/FAPC92, p. 17]**

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 Statement of Financial Accounting Standards No. 12, "Accounting for Certain Marketable Securities," they have market values that are relatively easily determined by frequent trades in markets of sizable breadth 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 4] **[AIMR/FAPC92, p. 25-26]**

To improve financial reporting, from an analyst's point of view, [one analyst] recommended . . . the following. . . : [Also included in 1(b), 2(c), 3(a), 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 2(c) and 15] **[BEAR STEARNS, p. 2]**

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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.

9. Measurement Uncertainties

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	□

9. Measurement Uncertainties

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]**

- Additional disclosure of risks and uncertainties, commitments, and off-balance-sheet transactions should be made in the financial statements. [Also included in 10 and 19] **[FASOversight, p. 2]**

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 2(b)] **[AIMR/FAPC92, p. 21]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of alternative accounting procedures. During the discussion, a comment was made on measurement uncertainties.

Participant I-12
The accounting profession seems to have decided that discounted cash flow is the appropriate accounting disclosure. My difficulty with that is that when you use a discounted cash flow approach, you have to make certain interest rate assumptions and other assumptions. We don't know what assumptions are used nor the amounts to which they were applied. When you have a big change in interest rate, it suddenly changes the value of those cash flows. Another example is the present value of retirement obligations; there are a few companies that are using 9%-10% interest rate assumptions in today's environment and there is a risk there that is not very obvious. **[TI 12/9, p. 45]**

[Context] Meeting of the Investor Discussion Group on December 9, 1992. Part of the meeting was devoted to the topic of measurement uncertainties.

Committee/Staff/Observer
Question 10(d) relates to measurement uncertainties. Some of the amounts of the assets and liabilities at the reporting date are uncertain, and whether their amounts are materially correct will be confirmed by future events. The estimates involved in asset and liability measurements are referred to as measurement uncertainties. Some members of the Special Committee believe that investors too often are unaware of, or tend to forget, the extent to which amounts in financial statements are the results of estimates, assumptions and judgments. They believe the usefulness of financial reporting can be improved by requiring companies to disclose that uncertainties are inherent in measuring many financial statement items because measuring their reported amounts requires estimates, assumptions, judgments, and the application of various allocation procedures. Our question is: do you agree that a disclosure that would remind investors about the existence of measurement uncertainties would be a meaningful improvement in financial reporting? **[TI 12/9, p. 59-60]**

Participant I-12
Amen. **[TI 12/9, p. 60]**

Participant I-8
What do you mean? Just a paragraph that says that these are approximations? **[TI 12/9, p. 60]**

Committee/Staff/Observer
Let's get into detail. There are two different things; the first is a boilerplate type of disclosure (like on a cigarette pack) to tell people that the accounting numbers are not as precise as they appear. Would such a disclosure be helpful? But more importantly (the second thing), would you want disclosure of the assumptions made when it's not a definitive number? **[TI 12/9, p. 60]**

Participant I-4
Doesn't a company need that for its own liability? **[TI 12/9, p. 60]**

Participant I-7
I'll accept a boilerplate disclosure to the extent that there is specific disclosure for material information. **[TI 12/9, p. 60]**

Participant I-11
I think it's true that many people don't realize and people who do realize forget about the uncertainties going into the creation of financial statements. But there is so much boilerplate on everything anymore that it seems worthless to add one more piece of metal. In terms of the disclosure of each individual assumption, that strikes me as a logistic monstrosity. I suppose there could be some exception to my comment, for example stage of completion on construction projects. But by and large, I don't think we need it. **[TI 12/9, p. 61]**

Participant I-8
Stage of completion on construction projects is an area of abuse that I've seen in the past. I would agree with [participant I-11] on that. **[TI 12/9, p. 61]**

Participant I-11
That's one where I can see a reason for the disclosure. **[TI 12/9, p. 61]**

Participant I-7
A lot of this information is already provided in the 10-K: receivable reserves and inventory reserves. Also, in the annual report, when you break out the tax line, very often you can see things like warranty reserves as one example. So there is a lot of information already for material items. **[TI 12/9, p. 61]**

Participant I-4
I think a boilerplate disclosure is redundant if you believe that the market you're serving is the professional investment community. Hopefully, people in our profession know that these kinds of balances and reserves exist. **[TI 12/9, p. 61]**

Committee/Staff/Observer
Let's leave the boilerplate disclosure off the table. What about unique assumptions or measurements on the liability side; would you want disclosure of how the company arrive at them? **[TI 12/9, p. 61]**

Committee/Staff/Observer
For example, the company has a tax contingency; the IRS claims $200 million and the company is taking it to court. **[TI 12/9, p. 62]**

Participant I-7
That's material and that's disclosed. **[TI 12/9, p. 62]**

Committee/Staff/Observer
Another example is the assumptions that a company uses in establishing warranty reserves? Or factors that go into the computation of the present value of an item that is reflected on the balance sheet at present value? **[TI 12/9, p. 62]**

Participant I-8
There is a lot of examples. Companies have different inventory obsolescence policies. I'd love to know about that. **[TI 12/9, p. 62]**

Committee/Staff/Observer
Again if it were material? **[TI 12/9, p. 62]**

Participant I-8
Yes. **[TI 12/9, p. 62]**

Committee/Staff/Observer
Those are the kinds of things we're thinking about. Not just a boilerplate statement with respect to each balance sheet item, but disclosure about the major assumptions that go into the measurement of those items. **[TI 12/9, p. 62]**

Committee/Staff/Observer
Isn't the kind of information that [committee/staff/observer] is describing the kind of information you would obtain by probing on your own? **[TI 12/9, p. 63]**

Participant I-8
You try. **[TI 12/9, p. 63]**

Committee/Staff/Observer
If that's the case and it's pertinent to you, it seems that it should be in the financial statements. **[TI 12/9, p. 63]**

Participant I-8
We're all in favor of that. **[TI 12/9, p. 63]**

Participant I-5
Generally speaking, why wouldn't it already be disclosed in your accounting principle statement? **[TI 12/9, p. 63]**

Participant I-12
I would like once again to make my point about present value accounting. Everyone of us has gone to the retirement footnote and seen what kind of interest rate assumptions people are using. There's a lot of companies that we can see go bankrupt over the next 3 years because they're using very high projected returns (9-10%) and they're not getting those kinds of return in this environment. Those are adjustments that will have to be made at some point, I suspect. In the industries that I cover, you have a whole range of assets and liabilities that are valued on a present value basis. For mortgage banks, there is a form of discounted cash flows that is being applied as a required accounting convention, and I don't know what interest rates those are put on the books at. **[TI 12/9, p. 63]**

Participant I-7
There is only one company that I follow that is making an estimate in terms of environmental exposure. In the manufacturing industry, for an increasing number of companies, the environmental risk is rather extraordinary, and I have only one company that makes an attempt at telling you what they spent and forecast expected costs for 1 to 3 years. **[TI 12/9, p. 64]**

Committee/Staff/Observer
I'd like to ask [participant I-5] a follow-up question. Right now in the financial statements, footnote 1 tells you how the accountants grind on the numbers in a particular case. This issue deals with whether you want more disclosure in the financial statements that talk about management's subjective decisions that were added to that grinding? Or in some cases used in lieu of grinding? **[TI 12/9, p. 64]**

Participant I-5
I think that the accounting policy statement is not complete without that. **[TI 12/9, p. 64]**

Committee/Staff/Observer
No, the statement is a statement of accounting principles. What we're talking about here is something in addition to that. **[TI 12/9, p. 64]**

Committee/Staff/Observer
It's information about the method of applying a principle. **[TI 12/9, p. 64]**

Committee/Staff/Observer
You're going to read about what management thought about in arriving at an estimate. **[TI 12/9, p. 64]**

Participant I-5
Give us an example. **[TI 12/9, p. 64]**

Committee/Staff/Observer
With respect to the warranty, maybe it's not simply a mechanical process of looking at the current month's sales; instead, management makes some kind of judgment based on how it reads its current quality control information, and then they determine that the estimates should be based on certain specific factors. The information you would be getting is the factors they took into account, without getting any numerical calculations as a result of that. **[TI 12/9, p. 64-65]**

Participant I-5
If that was a big deal, wouldn't that be in an individual note about those numbers? **[TI 12/9, p. 65]**

Committee/Staff/Observer
No. What we're saying is management has complied with generally accepted accounting principles in arriving at its determination of liability under product warranties. All you have is a number. What we're asking is whether you want to know about the assumptions used by management to arrive at that number? **[TI 12/9, p. 65]**

Participant I-7
If we're not talking about a case of fraud, management is in a better position to do that than I am. So the only time I would want the information is if we're talking about like product and there is a material change in the warranty. **[TI 12/9, p. 65]**

Committee/Staff/Observer
Let's assume that management legitimately came up with $1,000 for that warranty liability. Something happens and the next year, instead of $1,000, it's $1 million and the company's stock goes down by half and somebody asks the auditor how he could have passed on those financial statements when there is no disclosure about how they arrive at $1 million. **[TI 12/9, p. 65]**

Participant I-12
We have a real-world example: the S&Ls and their loan loss reserves. **[TI 12/9, p. 65]**

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 4] **[TI 12/9, p. 65-66]**

Participant I-5
If there's materiality in the outcome, then we should know what those assumptions are and I think that this is the general rule now, isn't it? **[TI 12/9, p. 66]**

Committee/Staff/Observer
No. I think you're mixing up disclosure in accounting principles versus how management arrives at its estimate of a number. **[TI 12/9, p. 66]**

[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 measurement uncertainties.

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 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 2(b) and 4] **[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 4] **[TI 1/13, p. 24]**

[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, comments were made on measurement uncertainties.

Participant I-7
We have discussed in previous meetings that in going through your procedures, estimates were made so that not everything is specific to the dollar. Estimates are made in your audit procedures that are of such significance that, if a different route had been chosen, there may have been a material change in the end result. We'd like to know about that. [Also included in 17(a) and 17(c)] **[TI 3/17, p. 5]**

Participant I-12
Where the greatest problems have come up is when the auditors have to rely on assertions and opinions of management. In a world that is changing as rapidly as ours, managements are highly capable of misleading themselves. I'm not sure if this is really the arena in which auditors should work, but it seems to be where I've seen the biggest issues come up. For example, everyone is sort of going along business as usual, then there's a major change in the environment, and nobody catches the fact that this will have a material effect in terms of the financial statements. [Also included in 17(a)] **[TI 3/17, p. 5]**

I'm not even sure that that's the arena of the auditors. I harked back to the change in tax law in 1986 which had enormous implications on the future of real estate partnerships. One would think that perhaps such things should be given more prominence in the financial statements or audit reports. Things of that nature should somehow be highlighted. [Also included in 17(a) and 17(c)] **[TI 3/17, p. 5-6]**

Committee/Staff/Observer
[Participant I-12], is it an audit issue or an accounting issue? To the extent that the accounting is driven by management judgements or decisions, is that maybe where your concern is? Or is your concern with respect to auditors auditing the subjective and the intangible? [Also included in 17(a)] **[TI 3/17, p. 6]**

Participant I-12
It seems to me that it's all wrapped up together. The accounting profession is accounting for various transactions and that gets colored by whatever the current rules are; if you change the rules, the accounting will change. So it is an accounting issue. There is also an auditing element in that the auditors ought to be caught up with those changes and changes in the environment, and they should have a role to play in the reporting process. But I don't know what that role is. [Also included in 17(a)] **[TI 3/17, p. 6]**

Committee/Staff/Observer
It sounds like what you and [participant I-16] are saying is the same. Our audit report now is kind of a one-size-fits-all report, very standardized. But the world is becoming more and more subjective, decisions have to be made more rapidly, and the impact on longer term assets is more and more uncertain; so it would be useful if the audit report could reflect that environment. [Also included in 17(a) and 17(c)] **[TI 3/17, p. 6]**

Participant I-16
When I first became a financial analyst 20 years ago, the major concern one had was the choice of accounting principles of management and how they could affect the numbers. Over the last 5 years, we know that what's really important are the estimates. When you see the enormous write-offs that companies have made in the last few years, they're basically saying that for years they have overstated their earnings by making bad estimates. Yet, auditors have not acknowledged that problem in their report. They also do not acknowledge when a company, every year for 5 straight years, has a huge write-off of assets in the fourth quarter, which says that they have been misleading people for eternity by capitalizing expenses. [Also included in 17(a) and 17(c)] **[TI 3/17, p. 6-7]**

Participant I-12
I'm not sure that management is deliberately misleading people. One of my issues with accounting and auditing is the use of assumptions and estimates and making those transparent. Because they're not always transparent to an analyst. There is a lot of room to change the appearance of financial statements based on the assumptions and estimates. [Also included in 17(a)] **[TI 3/17, p. 7]**

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 2(b) and 17(b)] **[TI 3/17, p. 10]**

Participant I-11
A central issue to these discussions is what the role of the auditor is or should be. I think that we may be looking at auditors to do more than they should be doing, using that as an excuse not to do it ourselves. The broad issue is that the financial statements of a company are supposed to accurately reflect the operating performance of that company. The proper role of the auditor is to provide independent judgement that the financial statements do provide an accurate reflection of the operating results. If you think of the role of the auditor in those terms, then expecting of the auditor to get involved in things like the MD&A or the company's forecasts are not appropriate functions for the auditor. On the other hand, issues relating to uncertainty of estimates are related to the auditor's role. To the extent that it is economically feasible, we ought to have a lot more information in that area. There is some limit based on

cost-effectiveness. For example, I'm not sure that it is cost-effective to have a quarterly audit. [Also included in 17(b) and 17(d)] **[TI 3/17, p. 11]**

Participant I-12
I would agree with that. I know that a lot of companies that I cover have their statements audited not only quarterly but before they report, which I find astounding for companies who report 10 days after the end of the quarter. I don't see any need to have an audit done more than annually. I also think that there are areas where the auditor might become involved; measurement uncertainties, for example. Another area for auditors would be looking at transactions with related parties (including major suppliers and major customers). In close relationships like that, that's where a company has the greatest potential for trying to cook the books. An auditor could look at those transactions and determine whether they're being accounted for on an arm's length basis. [Also included in 17(b) and 17(d)] **[TI 3/17, p. 11-12]**

Participant I-7
I'm not sure whether I can ask an auditor to measure one company's reporting against another. In the course of an audit, the auditor comes across certain paths in which estimates and assumptions are made; if those estimates and assumptions are continuously made in favor of the company and they are material relative to the bottom line, I'd like to know that on a qualitative basis. [Also included in 17(c)] **[TI 3/17, p. 13]**

Committee/Staff/Observer
How would you deal with the fact that auditors very often cannot deal with competitors? So in major industries, each company is audited by a different auditor. How do you get a meaningful comparison of a peer group by the auditor? [Also included in 17(c)] **[TI 3/17, p. 13]**

Participant I-7
It would be extremely difficult to ask the auditor to know what's going on elsewhere in the industry. But in the course of the audit, you know that certain assumptions and estimates are made, and you know enough about the particular business that making different estimates would have a material effect; that could be disclosed. [Also included in 17(c)] **[TI 3/17, p. 14]**

Participant I-12
It would be very helpful to learn about all those things, to get some viewpoint from someone who sees things far more closely than we do; the management information systems, management's assumptions, range of accounting principles that they are using. All of those things would be extremely useful. [Also included in 17(c)] **[TI 3/17, p. 15]**

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 1(d) and 17(c)] **[TI 3/17, p. 16]**

Committee/Staff/Observer
I'd like to challenge that. Management makes a projection which is based upon estimates and assumptions. You said you want us to be involved in historical financial statements, in either expanding in a note or in an AD&A, by having standards to disclose more about measurement uncertainties. Those same uncertainties enter into a projection. As a starting point, couldn't the auditor be properly involved in a projection by expressing an opinion about whether management's assumptions are realistic (based on x dollars, x volume, x units)? [Also included in 12 and 17(c)] **[TI 3/17, p. 18]**

Participant I-12
That's our business, that's what we do. There's no need for us if the auditor is going to do it. [Also included in 12 and 17(c)] **[TI 3/17, p. 18]**

Committee/Staff/Observer
Let's suppose you have the financial statements of an institution that has a large portfolio of real estate loans. This group and others have told us that they would expect the auditor to evaluate management's assumptions about whether those real estate properties are going to be profitable or not, and to make judgements about whether the carrying values of the assets are appropriate or not, whether they should be reserved, and you expect the financial reporting to reflect the appropriate adjustments. How is that different from other kinds of projections? [Also included in 17(b) and 17(c)] **[TI 3/17, p. 18]**

Participant I-12
For real estate properties, there are current appraisals on most of these properties. Theoretically, banks and other financial institutions have set aside reserves to appropriately reduce the value of the assets to reflect the current situation. I don't know if real estate prices are going to go up or down; I will look at all of that and I'll make an estimate of my own. What I would like the accounting profession to do is to make it clear to me what the basis of all of that is. A question analysts ask a lot is: what percentage of original value have your nonperforming real estate loans be written down? If we know how much has already been written down, we then have some information that will help us make estimates about how much more write-downs should be made given our general outlook. I would like to know what has already been done and what the status is. Managements are always making estimates; analysts try to know what the assumptions are and make their own estimates that can be radically different. I'm not sure the accounting profession needs to get involved in future estimates; the most important function of financial statements is clarity. [Also included in 12, 17(b), and 17(c)] **[TI 3/17, p. 18-19]**

[Context] Meeting of the Investor Discussion Group on March 17, 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 measurement uncertainties.

Participant I-16
I would agree with numbers 3 (unconsolidated entities) and 12 (interim reporting). I would add numbers 5 (business combination practices), 8 (disclosure of measurement uncertainties), and 16 (impairment); for number 16, I'm more concerned about long-lived assets than receivables. For number 8, I'm concerned with getting more explanations about where things are and come from. Business combination practices is an area where we don't understand how companies account for acquisitions; they don't explain that and you can't follow it. [Also included in 8(b) and 15] **[TI 3/17, p. 66]**

[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, a comment was made on measurement uncertainties.

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), 2(c), and 19] **[TC 12/8, p. 41]**

[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 measurement uncertainties.

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 4] **[TC 2/2, p. 6]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of disclosure about measurement uncertainties.

Committee/Staff/Observer
I'd like to deal with one last topic on my list, which has to do with the measurement uncertainties inherent in accounting information. Risks and uncertainties are in two different forms, both with respect to reported assets and the contingent liabilities. This has to do with the inherent imprecision of estimates inside the balance sheet. Without necessarily identifying all the items that fall under that canopy, but just acknowledging in a greater way that there are these kinds of uncertainties, reminding people that estimates are, therefore, subject to change from time to time, would that improve financial reporting and help users? **[TC 2/2, p. 49]**

Participant C-11
The way you just described this, I would call it boilerplate, and I would totally ignore the whole thing. I would expect to find the same kind of statement in every annual report I picked up. **[TC 2/2, p. 49]**

Participant C-13
I agree. I think people disregard it. **[TC 2/2, p. 49]**

Participant C-15
I think that the things we talked about earlier such as the aging of receivables, are much better ways to get at answers. Maybe the one area where it might benefit would be for some non-sophisticated users. I think that we're all aware of the differences or potential differences. But someone who's not used to dealing with financial statements, not a sophisticated user of financial statements, tends to take numbers at their face value. So for non-sophisticated users, I think to point out, even if we would consider it boilerplate or a disclaimer, it might raise someone's level of awareness. That what you see may not be exactly what's there. **[TC 2/2, p. 49-50]**

Committee/Staff/Observer
I understand that one type of disclosure would be boilerplate, the acknowledgment that it's inherently risky. The second type of disclosure could deal with how much do you want to know about these estimates. If we go to page 24, it proposes that there could be a variety of approaches to telling users more about things that underlie assumptions. Sometimes it could be something as simple as the aging of accounts receivable to show a little bit more about how the bad debt reserve might relate to it. In other cases, it might be much more complicated to

talk about, for example, warranty experience and quality controls inherent in manufacturing process, and some other fairly in-depth discussions. Is this useful information? Is the financial report the correct place to put it? What is your feeling as a user, if that is what you want? How do you deal with it? How would you expect the package to look to make it useful? [Also included in 17(b)] **[TC 2/2, p. 50]**

Participant C-5
I don't know if I would have an auditor provide that. [Also included in 17(b)] **[TC 2/2, p. 50]**

Participant C-4
I think some information that might be helpful is hindsight review: estimated cost of completion on long-term contracts are obviously a huge estimate that significantly impacts earnings. If there were some comment made that at the prior year end the estimate for cost to complete was within a certain range of what the actual final costs were. Using that as a basis for the current estimated cost, is giving us some historical information which is not readily available. It may just be about allowances for doubtful accounts and what actually that expense was. That type of information. It may be just a footnote disclosure. **[TC 2/2, p. 50]**

Participant C-13
I think that, basically, it's hard to argue with the usefulness and even importance of most of these disclosures. Obviously, some are relevant. **[TC 2/2, p. 50]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 12

a. While some have proposed a *general* disclosure stating that "financial statements reflect the results of estimates, assumptions, judgments, and allocations that are inherently uncertain", the disclosure would be considered "boilerplate" and would have little or no value to investors, analysts, and other users of financial statements.

Do you_ AGREE? 12 _ DISAGREE? 2

Comments:

Participant C-17: Basis of disclosures is always important and may not be boilerplate if there are basis modifications from company or industry to industry.

Participant C-18: Complete waste of paper. CYA statement only.

Participant C-2: <u>But</u> the statement still has value for novice or infrequent statement users.

Participant C-12: If management goes further to state <u>which</u> specific estimates, etc. are the most uncertain and which have the most impact on financial statements, then we might have something.

Participant C-14: How does this statement help?

Participant C-15: In general, I agree for sophisticated users. This might be helpful for non-sophisticated users.

b. Do you think that some of the amounts in financial statements should be subject to more detailed disclosure of how the uncertain amounts were derived and the nature of the estimates, assumptions, judgments, and allocation procedures used in measuring them?

13 _ Yes 1 _ No

Comments

Participant C-18: Only if meet materiality test.

Participant C-13: If there are significant uncertainties, it is mandatory - I would have thought - to disclose them in MD&A.

Participant C-5: Information sufficient to allow users to make their own estimates should be required.

Participant C-4: Should disclose how estimates for doubtful accounts, cost to complete, etc. compare to actual historic results.

Participant C-14: Maybe if material.

If YES, do you think (please check the appropriate box)

_ 6 The information to be disclosed should be specifically mandated by accounting standards setters (creating a uniform, mandated disclosure requirement)? or

_ 7 The information to be disclosed should be selected by management and auditors based on the specific circumstances of each company (leaving disclosure significantly subject to professional judgment)?

[PMQC 2/2, p. 21-22]

[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 disclosure about measurement uncertainties.

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 5(b) 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 5(b) and 17(a)] **[TC 3/11, p. 14]**

Participant C-8
In the construction industry, GAAP rules often don't reflect the reality of the business. The ability of a contractor to book and carry construction claims, to carry contract costs in excess of contract billings, and things like that; GAAP generally don't reflect just how questionable and volatile those assets are. That's probably the case in a lot of other industries as well. **[TC 3/11, p. 17]**

Participant C-4
We're hitting at what the role of the auditor is. And if we're asking the auditor to make assessments about what the business risks are, I think that's really beyond the scope of what we want. I would be more interested in the auditor disclosing at what level they've audited from a materiality standpoint, and what has taken place from a statistics standpoint. What were the basis for their estimates for doubtful accounts? And on a hindsight basis, how do these current estimates compared to the prior year results? So some format of factual presentation as opposed to their doing the assessment. We'll do the assessment but we would like more information about how estimates were arrived at. [Also included in 17(b) and 17(c)] **[TC 3/11, p. 33]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 18

Current financial reporting standards require neither (a) disclosure of the fact that uncertainties resulting from estimates, assumptions, and judgments or from allocations (or both) are inherent in measuring most of the amounts in financial statements nor (b) disclosure of the significant uncertainties underlying those amounts.

a. While some have proposed a general requirement to disclose that financial statements reflect the results of estimates, assumptions, judgments, and allocations that are inherently uncertain, disclosure of information of that kind would be considered "boilerplate" and would have little or no value to investors, analysts, and other users of financial statements.

Do you
AGREE?
7
DISAGREE?

Comments
Participant I-8: Nevertheless such a statement might be of some benefit to the less sophisticated.
Participant I-11: Such a disclosure would do no harm, but it contributes no information to a sophisticated user (and probably no real information to an unsophisticated user, for that matter).
Participant I-12: A simple "hedge clause" would simply provide management with some legal protection. More detail is needed.

b. Do you think that some of the amounts in financial statements should be subject to more detailed disclosure of how the uncertain amounts were derived and the nature of the estimates, assumptions, judgments, and allocation procedures used in measuring them?

Yes *6* No *1*

If you think that more detailed disclosure of information is needed, do you think (please check the appropriate box)

The information to be disclosed should be specifically mandated by accounting standards setters (consequently creating a uniform, mandated requirement to disclose the information)? *Participant I-12*: Focus on materiality.	*1*
The information to be disclosed should be selected by management and auditors based on the specific circumstances of each company (consequently leaving disclosure significantly subject to professional judgment)?	*5*

[PMQI 12/9 and 1/13, p. 35-36]

Objective 4 [Improve the common understanding of the nature and purposes of information contained in financial reports]. None of the FASB's objectives are easily attained. Objective 4 is one of the more elusive. This is in part true because "improving the common understanding" of anything is difficult given the static inherent in the era's dependence on the media as a communications tool. The media fastened on Statements 87 and 106 during their gestation periods, as well as following their release. We hope that such attention may have helped to communicate some of the benefit that such accounting standards provide. We also hope that it encourages comprehension that "the basic objective of financial statements is to provide information useful for making economic decisions."[6] **[AIMR/FAF91, p. 17-18]**

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), 5(c), 6, 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, 5(a), 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 1(b), 4, 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), 4, 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), 4, 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), 4, 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), 4, and 15] **[BETRIOU, p. 3]**

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[6] <u>Objectives of Financial Statements</u>, at 13.

10. Operating Opportunities and Risks

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	□

10(a). Definition

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]**

- Additional disclosure of risks and uncertainties, commitments, and off-balance-sheet transactions should be made in the financial statements. [Also included in 9 and 19] **[FASOversight, p. 2]**

[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.

Committee/Staff/Observer
Let's move on to the third and final category of questions for today; information about operating opportunities and risks. We define operating opportunities and risks as 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. In previous meetings, you have emphasized to us the importance of understanding the operating opportunities and risks facing the company. Thus, the Special Committee is considering how external reporting could provide the information that investors and creditors need to help them assess the potential effects of operating opportunities and risks that are not yet recordable in the accounts and recognized in the financial statements. What sources do you currently use to get information about a company's opportunities and risks, as the Special Committee has defined that term? **[TI 1/13, p. 43]**

Is the Special Committee's definition of operating opportunities and risks a workable definition? If not, how would you change the definition? **[TI 1/13, p. 43]**

Participant I-11
I think that's a reasonable definition. **[TI 1/13, p. 43]**

Participant I-12
Where does the notion of steps the company has taken to mitigate risks come up? I'm thinking particularly about swaps and derivatives. [Also included in 19] **[TI 1/13, p. 44]**

[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.

Committee/Staff/Observer
Let's stop questions about cash flow at this point and go to page 18. The discussion at the top of the page explains that there are really two sets of risks and uncertainties. And we've already talked about one earlier today when we talked about risks and uncertainties with respect to things already on the balance sheet, for example-agings of accounts receivable, slow moving inventory, things like that. But there's a whole bunch of other risk and uncertainties that have to do with things that have happened or may happen that change future cash flows, but don't have any corresponding recorded balances in the income statement or the balance sheet. For example, things like changes in relationship with customers, or suppliers, changes in relationship with lenders. A lot of things that have to do with the external world. The question that is one the table is whether or not these need to have a more formal form of being addressed in a financial reporting package? That is, should there be a discussion of risks and opportunities and certainties that relate to things that are more than simply recorded balances? Operating opportunities risk are beneficial and detrimental circumstances in which the company is involved with at the reporting date, and these are the key words, that are not assets or liabilities, but that may cause the reporting entity to have increases or decreases in cash flows in the future. The first thing that the special committee is interested in your comments about is, is that a useful working definition? **[TC 2/2, p. 27-28]**

Participant C-7
I'd go along with it because I guess I'm focusing on the word "operating" and in discussions we had before we said operations are those items within the purview or control, or potential control of management. If that's what we're trying to evaluate, I thing that's appropriate. **[TC 2/2, p. 28]**

Participant C-11
Would this be something like in a prospectus for a somewhat speculative security? Are there any legal or accounting or SEC guidelines that have been framed from that? [Also included in 10(b)] **[TC 2/2, p. 28]**

Committee/Staff/Observer
I think you can view it as somewhat of a Venn diagram where some of the things that you see under the risk section of a prospectus, and some of the things you see in a MD&A, may be well scooped up under this definition. There may be other things that are not in that area, that would also be scooped up, particularly things that might be outside MD&A. Now, they may not be outside risk factors. But they would be things that are not yet known trends, but could be trends. That's where MD&A slices off. Did I answer your question? [Also included in 10(b)] **[TC 2/2, p. 28]**

Participant C-11
Just to be contrarian, I'm not sure that I know what this means. And I'm talking about the borderline between concerns you may have or just strong beliefs about positive things at the

time you're doing your statements. I don't see that this definition really gives you any guidance as to the difference between those two things. For example, thinking about the current method of loan loss reserving where companies I think very appropriately may have an element of unallocated reserves reflecting the risks and uncertainties of loans on the books that are not performing or future loans. [Also included in 10(b)] **[TC 2/2, p. 28-29]**

Committee/Staff/Observer
To my knowledge, reserves relate to loans on the books. [Also included in 10(b)] **[TC 2/2, p. 29]**

Participant C-11
I think perhaps we're having a semantic problem here. [Also included in 10(b)] **[TC 2/2, p. 29]**

Participant C-17
In financial statements today, what's being evaluated is really what the risks are. It's not so much the opportunities. But I certainly get a little uncomfortable when you start talking about getting together with the auditor to project opportunities. You know, I'm not sure that's what we should do. [Also included in 17(b)] **[TC 2/2, p. 29]**

Participant C-5
I would say that I like the definition. I would focus the disclosures on environmental factors, over which management has no control, that may affect the company's business and future cash flow prospects. **[TC 2/2, p. 29]**

Participant C-4
I've got an example that I think has worked very well. In Pennsylvania, workers' compensation is 3%; if a contractor has a job locked in at certain prices, you know that there's going to be a profit; under current accounting, I would say that's neither a liability or a contingent liability. But it's going to have a major impact on the cash flows of that contract and it should be disclosed. So that's the type of information that, if I'm a creditor and I'm loaning somebody doing business, I would want that information disclosed to me. Another example would be a major change in their insurance program and the risk management program. [Also included in 10(b)] **[TC 2/2, p. 29]**

Participant C-2
Perhaps I'm guilty of reading this far too literally, but for me the word that troubled me most I guess was this "involved". Just how involved? Directly involved or indirectly involved? And it seems to me that this opens up a universe of possibilities that would result in huge cost to the preparer and to the preparer or the attester and that really concern me. **[TC 2/2, p. 30]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 19 - Definition of Operating Opportunities and Risks and Relative Importance of Each

The Special Committee has defined operating opportunities and risks as follows:

> Operating opportunities and risks are beneficial or detrimental circumstances in which a company is involved at the reporting date that are not its assets or liabilities but that may cause the reporting entity to have increases or decreases in cash flows in the future.

Examples of events and circumstances that can affect a reporting entity in the future as much as the assets and liabilities[1] and changes in them that are displayed in its financial statements include trends in sales, sales prices, unit costs, and other factors; changes in markets, competition, or technology; and concentrations that develop in sources of supply, customers, or employees of the reporting entity. Those and other operating opportunities and risks are related to information in financial statements and often result from the same transactions and other events as assets, liabilities, revenues, expenses, and other items in financial statements, but one or more future transactions or other events must occur before the company obtains assets or incurs liabilities from transactions or other events that are still in progress or as a result of circumstances that are still developing.

a. Is the Committee's definition consistent with the way you think of operating opportunities and risks in evaluating the companies that you follow?

Yes *6* No

If No, how would you change the definition?
[PMQI 12/9 and 1/13, p. 37]

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[1]"Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 25).
"Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (Concepts Statement No. 6, paragraph 35]

10(b). Types of Opportunities and Risks That Should be Disclosed

[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 5(a) 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 [item] should be included in the single body of accounting concepts, standards, principles and methods: **[RMA90, p. 5]**

- Variations in income between years ("swings") should be explained either in footnotes or in supplementary analyses, such as the "Management Discussion and Analysis" (MD&A) that the Securities and Exchange Commission requires of all publicly-owned companies. **[RMA90, p. 7]**

[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.

Committee/Staff/Observer
The number and variety of operating opportunities and risks that companies face can be rather daunting. The Special Committee has been trying to develop a framework for identifying those opportunities and risks that should be disclosed in external reporting. The meeting materials referred to 3 frameworks that may help in identifying the appropriate opportunities and risks. We would like your reaction to those frameworks. **[TI 1/13, p. 44-45]**

The first framework mentioned in the materials is the list of nonfinancial business information that we discussed with you at our first meeting back in October. You may recall that the list was categorized into 3 sections: information about the economy, the company's industry, and the company itself. Our question is: to what extent would the information on the list provide the information that you need to know about the company's operating opportunities and risks? Does that list provide a workable framework for categorizing and disclosing what you need to know about operating opportunities and risks? Is the list a promising starting point or basis from which to develop an accounting standard requiring disclosure of information about operating opportunities and risks? **[TI 1/13, p. 45]**

Participant I-8
You tend to get from management now much more attention to opportunities and much less attention to risks. **[TI 1/13, p. 45]**

Committee/Staff/Observer
Do they talk to you about opportunities in one-on-one kinds of situations as opposed to telling you about opportunities in the normal course of their business reporting? **[TI 1/13, p. 45]**

Participant I-7
The answer is yes. Every company will tell you about their opportunities privately but, in formal presentations, discussing certain things like marketing strategies is not done and I believe it shouldn't be done. Talking about new products and pricing strategies, that type of information you don't get in dialogues and I understand that. **[TI 1/13, p. 45]**

Participant I-8
I think there should be more of a push on talking about risks and problems. **[TI 1/13, p. 45]**

Participant I-7
One way you can get some sense in terms of risk management is to talk to the company about what their outlook is. If they have a glowing outlook, and you're making a bet that it isn't, you know that they're structuring their organization for that outlook from a cost point of view, and somewhere along the way they might minimize the risk. **[TI 1/13, p. 46]**

Participant I-12
We get quite a bit on risks and opportunities in a lot of the SEC documents. There is a big section in the K talking about the underlying business; it almost parallels what you see in a prospectus. You get a lot of information in prospectuses as well. [Also included in 10(d)] **[TI 1/13, p. 46]**

Participant I-7
I found those statements being nothing more, for the most part, than disclaimers. Management knows quite well what the risks are; we should get more of that information in detailed form rather than just broad disclaimers. [Also included in 10(d)] **[TI 1/13, p. 46]**

Committee/Staff/Observer
You would then be in favor of us developing an accounting standard that would require disclosure, more than a disclaimer, about true analysis of the risks and opportunities? **[TI 1/13, p. 46]**

Participant I-7
If that's what it takes to get it, the answer is yes. **[TI 1/13, p. 46]**

Committee/Staff/Observer
[Participant I-12], in your focus on prospectuses, is the presentation well balanced or does it focus almost exclusively on the risk side rather than also on the opportunity side? **[TI 1/13, p. 46]**

Participant I-12
Prospectuses emphasize more the risk side. On the other hand, that provides balance to the annual report where more emphasis is placed on the opportunity side. Another thought is that

the analyst's job is to ferret out those risks and returns because lots of times management may not be even aware of it. Analysts make their own determination of what the real value is, where the real risks and opportunities are. **[TI 1/13, p. 46-47]**

Committee/Staff/Observer
There are many companies that are not followed by analysts. Should there be a standard that provides shareholders with getting financial reporting from the company, without the benefit of an analyst interpreting it for them, about opportunities and risks? **[TI 1/13, p. 47]**

Participant I-8
There should be an attempt, absolutely. **[TI 1/13, p. 47]**

Participant I-14
I'm astonished that the impetus to this doesn't come from the companies themselves. If something goes wrong that they might have known about, they're sued. **[TI 1/13, p. 47]**

Participant I-8
That's only recent. Before recently, the prospectus was the basis of class action; now, it's just lousy results that trigger a suit. **[TI 1/13, p. 47]**

Committee/Staff/Observer
My fear is that it will lead you to an out of balance situation; there will be less discussion about opportunities because the cost of being wrong will be so great and companies will play things closer to their vest. **[TI 1/13, p. 47]**

Participant I-8
You're not going to be able to prevent that. On the other hand, maybe you can help companies in terms of formalizing some risk disclosures that help insulate them from the worst part of what the lawyers are doing. **[TI 1/13, p. 47]**

Participant I-12
In our work on the annual report survey, one of the things we stress is that the chairman's letter really needs to address what went right and what went wrong in the past year, where they are today, and what they are going to try to achieve in the coming year. There is an awful lot of chairman's letters that get very low scores. Maybe we need a standard, I don't know. **[TI 1/13, p. 47-48]**

Committee/Staff/Observer
[T]he 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 2(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 2(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 2(b) and 13] **[TI 1/13, p. 49]**

Participant I-11
Yes, the MD&A provides a promising starting point. But I think that in the vast majority of cases, the present MD&A is a joke. There is a vehicle there that could be used to do what it's supposed to do, but it sure isn't being used for that now. The bad news about the MD&A is that it is an SEC-required thing and it tends to be filled at the lowest possible level. [Also included in 13] **[TI 1/13, p. 49]**

Participant I-8
I'm not aware of one instance where the SEC has challenged even after the fact what a company wrote in an MD&A. [Also included in 13] **[TI 1/13, p. 49]**

Committee/Staff/Observer
They have. [Also included in 13] **[TI 1/13, p. 49]**

Committee/Staff/Observer
Do you think that the filling out to the lowest level would change if it were an accounting standard versus an SEC requirement? [Also included in 13] **[TI 1/13, p. 49]**

Participant I-11
I think there would be a better chance of it. The idea behind the MD&A was clearly a good one, the execution clearly has been a failure. It seems to me that over the years the accounting profession has had a little more leverage in getting some of these changes effected than the SEC has had. [Also included in 13] **[TI 1/13, p. 49]**

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 3(a) and 13] **[TI 1/13, p. 50]**

Participant I-12
I've had companies tell me that if they didn't write the MD&A that way, it would take months to get the annual report out of the SEC. The SEC is looking for certain types of descriptive phrases; it's boilerplate. Part of the reason the MD&A is not that useful, a good structure but not that useful, is because we're looking at accounting items that are not necessarily the relevant ones. Perhaps it would be better if the MD&A evolves into more disclosures about lines of business. [Also included in 13] **[TI 1/13, p. 50]**

The big problem I have with current disclosure on derivatives is that it is highly misleading, that is, to disclose notional amounts in a business where the principal is truly not at risk. For most derivatives, it's not a principal risk business; cash flows are being exchanged and it's more of an interest rate risk business (at least for swaps). The current disclosure overstates the risks in some contracts and understates the risks in other contracts. It's very difficult to understand what the huge lump sum number being disclosed mean. What are the real risks and opportunities? [Also included in 19] **[TI 1/13, p. 50]**

Committee/Staff/Observer
One of the reasons for the problems with the disclosure is that we don't have agreement on what the right accounting should be. Until we get that, it's a little hard to address these risks. [Also included in 19] **[TI 1/13, p. 50]**

Committee/Staff/Observer
Is it possible, [participant I-12], that some kind of a sensitivity analysis, or a stress test, on those instruments would be more meaningful in terms of how they move in relation to interest rate changes and how they are related to the instruments they're linked to? [Also included in 10(c) and 19] **[TI 1/13, p. 51]**

Participant I-12
I think that something along those lines could be very useful. There are people who are using those instruments who I suspect haven't the foggiest notion of what they've got. There is a lot of work that needs to be done. [Also included in 10(c) and 19] **[TI 1/13, p. 51]**

Participant I-11
[Participant I-12] isn't part of the problem on that issue the fact that even the participants don't understand the risks? We've seen a number of cases in the past few years where some risk-reducing derivative transaction proved not to work, like portfolio insurance. From my perspective, I think the understanding of the nature of the risks in that whole business is very poor. [Also included in 19] **[TI 1/13, p. 51]**

Participant I-12
I think there is a dealer community that really does understand what they're doing. And there are some unscrupulous people who are selling these things to companies who don't know what they're doing. Maybe by having an accounting that makes better sense, it would point out to them that they're getting into something they don't understand. [Also included in 19] **[TI 1/13, p. 51]**

Participant I-5
The dealer community may know the risks for derivatives that have been around for 5 years, but every year there is something new that comes out and they may not know so well what the risks are. [Also included in 19] **[TI 1/13, p. 51]**

Participant I-14
When you get into the big international pharmaceutical or consumer goods companies, especially in a year where there has been a huge currency change, I question whether hedging will do everything. I think that's going to be a very big issue. I don't know how many companies will be very clear about the effects of currency fluctuations on their results. [Also included in 19] **[TI 1/13, p. 52]**

Participant I-12
It's not only the big international companies. I was looking recently at a small thrift ($200 million in assets) that had 2 or 3 million dollars in contracts; if the yield curve changed its shape, this company could have real problems or huge gains. [Also included in 19] **[TI 1/13, p. 52]**

Committee/Staff/Observer
Let me get to a third framework and that's the AICPA proposal. The Institute recommends disclosure in 3 categories: (1) to describe the nature of operations, (2) to discuss current vulnerability due to concentrations, and (3) to discuss the company's financial flexibility. Our question is: do these 3 categories provide a workable framework for categorizing and disclosing what you need to know about operating opportunities and risks? Is it a promising starting point for an accounting standard? Is the focus on risks rather than opportunities reasonable? And is information about risks more relevant to investors than information about opportunities? **[TI 1/13, p. 52]**

Participant I-11
The focus on risks and uncertainties is appropriate. I don't think there is any shortage of information for us about opportunities. I think there are some realistic limits about what we ought to expect the accounting profession to address in that arena, and it seems to me that information about concentrations and financial flexibility is material and reasonably quantifiable and appropriate. **[TI 1/13, p. 52]**

Participant I-15
It's a good starting point but there should be greater elaboration on the concentration disclosures between the production base versus the sale base (in geographic terms). **[TI 1/13, p. 53]**

Participant I-12
The issue of concentration is important. There are a number of issues that have come out over recent years in the financial services industry (for example, bad loans that turned into a real estate concentration because of the repossession of collateral) that make it difficult to define concentration. And there is also the issue of what is material. **[TI 1/13, p. 53]**

Participant I-11
If you set a very low materiality threshold, let's say 1%, don't you run the risk of having so much risk to disclose that people will tend to treat it as litigation protection and ignore it, and it becomes valueless? [Also included in 18(b)] **[TI 1/13, p. 53]**

Committee/Staff/Observer
The definition that the AICPA is using is "make the enterprise vulnerable to risk of severe impact on near-term cash flows or results of operations". They tried to focus on things that you better pay some attention to right now. **[TI 1/13, p. 53]**

Participant I-11
That's the context in which I would define it. **[TI 1/13, p. 53]**

Participant I-7
I don't have a problem with that; it's a starting point. **[TI 1/13, p. 53]**

Committee/Staff/Observer
Thus far, our discussion has focused on how to identify the types of relevant operating opportunities and risks. The number and variety of risks and opportunities are endless, so let's turn our attention to the ways to narrow these opportunities and risks down to those that you most need to know about. Question 13 on pages 29 and 30 of the meeting materials identifies several screens that could be used to narrow the list of opportunities and risks[:

- 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.]

Our question is: which of these screens, if any, provide a good way of narrowing the list of opportunities and risks to be disclosed? Do you have any suggestions for better screens? **[TI 1/13, p. 53-54]**

Participant I-10
What do you mean by reasonably possible? **[TI 1/13, p. 54]**

Committee/Staff/Observer
I think the point that we want to address with the first bullet is: should we have a screen that screens out certain opportunities and risks based on probability, based on some measure of the likelihood of its occurrence? **[TI 1/13, p. 54]**

Participant I-10
The problem is that my assessment of the likelihood of an event may be very different from yours. **[TI 1/13, p. 54]**

Committee/Staff/Observer
Do you feel differently about risks that you think have a low likelihood of happening versus those that have a high likelihood of happening? And is that a reasonable screen or do you want to know both? **[TI 1/13, p. 54]**

Participant I-11
I think it's a little more complex than that. The cut-off level gets lower as the risk gets higher. **[TI 1/13, p. 55]**

Committee/Staff/Observer
Which is the second bullet in the meeting materials. **[TI 1/13, p. 55]**

Participant I-11
If it's a life threatening situation, I want to know about it a lot more and a lot earlier than if it's a situation that might knock this quarter's earnings down 20% and then be gone. It's similar to analysing distribution companies where you look at a "turn and earn" index (gross margin times inventory turnover) and you get a figure of merit. This is kind of a risk and probability index; there's some figure of demerit that the two are intertwined in. Also, I think that a combination of all the bullets included in the meeting materials is appropriate. **[TI 1/13, p. 55]**

Participant I-10
It's a very complicated subject. You can have 5 different risks, each of which is unlikely to happen. But if they're all present, the likelihood of two of them happening is dramatically increased. For example, you look at insurance companies that insure municipal bonds. We know that if we have a disaster in America, not just Peoria won't be able to pay its bills. Risks are related to each other even though each risk may appear to be small. **[TI 1/13, p. 55]**

Participant I-12
I feel very uncomfortable with the notion of screens to determine which risks are highlighted or reported and which aren't for many of the reasons [participant I-10] just outlined. I think it's a good idea of letting people know what the risks are and where they are. But there are a lot of unforeseen events and you really are leaving it wide open for lawsuits and a lot of liabilities. I'm not sure it's worth it; it's good to have a list of what could go wrong but not to screen that list for disclosure. **[TI 1/13, p. 55]**

Participant I-7
We're constantly looking for more information. Risk measurement is a subjective element and I hate to force accountants into providing that information. Measurement is very difficult. **[TI 1/13, p. 56]**

Committee/Staff/Observer
On the other hand, there are all kinds of examples that you could talk about. For example, what are the risks and uncertainties of being a U.S. defense contractor? Is that something that management should talk about? **[TI 1/13, p. 56]**

Participant I-5
But it's something so general and broad that it might not be useful. **[TI 1/13, p. 56]**

Participant I-11
In trying to grapple with what the role of the accounting profession should be in this, it strikes me that the relevant issue is that we are dealing with firms that have had financial statements audited on an ongoing basis. I think the accountants should get involved when the risks and uncertainties threatened the company's going concern basis. I'm a lot less concerned with the opportunities side because I don't have any problems hearing about those. **[TI 1/13, p. 56-57]**

Committee/Staff/Observer
That says we stay where we are now? **[TI 1/13, p. 57]**

Participant I-11
Just about. **[TI 1/13, p. 57]**

Committee/Staff/Observer
Just to clarify one thing, [participant I-11]. In terms of your timeframe, when you say something is going to sink the company, what timeframe are you looking at? Is it 12 months, more than 12 months? **[TI 1/13, p. 57]**

Participant I-11
I'm not sure. **[TI 1/13, p. 57]**

Committee/Staff/Observer
[Participant I-11], is your willingness to accept current practice in part a function of your good knowledge of your industry and your ability to get the information through talking to various sources? Would you be willing to accept current practice if you didn't have access to those sources? [Also included in 10(d)] **[TI 1/13, p. 57]**

Participant I-11
I can't answer that question; I don't know. I'm in the business of getting that kind of information, I don't know how I would react otherwise. [Also included in 10(d)] **[TI 1/13, p. 58]**

Participant I-12
A lot of that information is available to people outside our profession through things like Investment Dealers Digest or some of these newsletters that go out, the business press, etc. It seems to me that a lot of the things that we see as analysts and portfolio managers are increasingly available to the general public. [Also included in 10(d)] **[TI 1/13, p. 58]**

[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.

Participant C-11
Would this be something like in a prospectus for a somewhat speculative security? Are there any legal or accounting or SEC guidelines that have been framed from that? [Also included in 10(a)] **[TC 2/2, p. 28]**

Committee/Staff/Observer
I think you can view it as somewhat of a Venn diagram where some of the things that you see under the risk section of a prospectus, and some of the things you see in a MD&A, may be well scooped up under this definition. There may be other things that are not in that area, that would also be scooped up, particularly things that might be outside MD&A. Now, they may not be outside risk factors. But they would be things that are not yet known trends, but could be trends. That's where MD&A slices off. Did I answer your question? [Also included in 10(a)] **[TC 2/2, p. 28]**

Participant C-11
Just to be contrarian, I'm not sure that I know what this means. And I'm talking about the borderline between concerns you may have or just strong beliefs about positive things at the time you're doing your statements. I don't see that this definition really gives you any guidance as to the difference between those two things. For example, thinking about the current method of loan loss reserving where companies I think very appropriately may have an element of unallocated reserves reflecting the risks and uncertainties of loans on the books that are not performing or future loans. [Also included in 10(a)] **[TC 2/2, p. 28-29]**

Committee/Staff/Observer
To my knowledge, reserves relate to loans on the books. [Also included in 10(a)] **[TC 2/2, p. 29]**

Participant C-11
I think perhaps we're having a semantic problem here. [Also included in 10(a)] **[TC 2/2, p. 29]**

Participant C-4
I've got an example that I think has worked very well. In Pennsylvania, workers' compensation is 3%; if a contractor has a job locked in at certain prices, you know that there's going to be a profit; under current accounting, I would say that's neither a liability or a contingent liability. But it's going to have a major impact on the cash flows of that contract and it should be disclosed. So that's the type of information that, if I'm a creditor and I'm loaning somebody doing business, I would want that information disclosed to me. Another example would be a major change in their insurance program and the risk management program. [Also included in 10(a)] **[TC 2/2, p. 29]**

Participant C-15
Would the disclosures run parallel to the SEC? Or separate from those? **[TC 2/2, p. 30]**

Committee/Staff/Observer
I don't want to imply that there is some kind of a very concrete proposal underneath all of this. But, right now, we'd be talking about things that are not in the universe that was required of financial statements. So whatever the SEC requires now, inside financial statements, what we're talking about is outside that boundary. **[TC 2/2, p. 30]**

Participant C-15
The SEC would have general guidelines about disclosure of factors the company is aware of that might impede trends at a certain point. Financial or not financial. **[TC 2/2, p. 30]**

Participant C-11
I'd like to make a rather flat statement. I think that the management discussion and analysis framework which developed at the beginning of the '80's is an excellent framework for discussion of these types of items with risk uncertainties. It obviously gets into the operating circumstances of the company, but also into issues of liquidity and capital and so forth that I think is superb. **[TC 2/2, p. 30-31]**

Committee/Staff/Observer
I want to ask you two questions, [participant C-11]. One is whether some pieces of the MD&A really should be included as part of the financial statements subject to audit oversight, and the second one is to the extent MD&A reports are always valuable, should it be extended, other than just the 10,000 public companies? **[TC 2/2, p. 31]**

Participant C-11
Those are two very different questions. On the first one, I would say, if there are certain types of things in the MD&A that went into a different framework, we should get a good definition and talk about what those might mean, as opposed to just going with this. **[TC 2/2, p. 31]**

Participant C-17
The way I look at this is that I want help from you folks in terms of being able to identify a quantifiable risk, something that's measurable. Insurance that you dropped. But I don't want an accountant getting involved in trying to determine the future. I think that's management's responsibility, and my responsibility. [Also included in 12] **[TC 2/2, p. 31]**

Participant C-13
I agree with that. I approach this whole thing with a fair degree of skepticism. I agree with what [participant C-11] said, I draw the analogy with the discussions of forecasting. I don't think that forecasting has a place in financial disclosure. And I don't think that what we're talking about here has a place in financial statements. Its place is elsewhere. [Also included in 12] **[TC 2/2, p. 31]**

Participant C-17
For example, I'd love to know that collective bargaining was going to commence quickly. I don't want you to interpret for me. I just want to know, hey, there's a risk there. **[TC 2/2, p. 32]**

Participant C-5
Item C in the meeting materials seems to be something where you could get a little bit more detailed without being subjective. I think that is something that is quantifiable within management's ability to provide to you. **[TC 2/2, p. 32]**

Participant C-14
Wouldn't these issues be discussed in MD&A if management felt as though they were going to be relevant or significant enough as to impair future cash flows? **[TC 2/2, p. 32]**

Participant C-5
My problem is that they never quantify it, they talk about all of it but, I don't get the sense they quantify the potential impact. **[TC 2/2, p. 32]**

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 2(d)] **[TC 2/2, p. 32]**

Participant C-4
We're small lenders. We don't get the MD&A information and if the accounting profession would take that upon themselves in that one area, that would be very useful information. **[TC 2/2, p. 32]**

Participant C-5
Just another example of the situation at [name deleted]. I have a lease expiring in 1994. It's nice they show you that, but they don't tell you that it's above market. It's above market by $26 and, therefore, I'd like you to have a reduction in my occupancy expense by this dollar amount. You know, the impact on future years' revenues, the future periods beyond that. There is a need for that. It just helps to build the historical financial statements; you're looking at the past to predict the future. And right now, we don't get that sort of flow from the historical forward as much as we should. [Also included in 10(c)] **[TC 2/2, p. 32-33]**

Participant C-11
I think we can repeat the words that we've been saying all the way through here. And that is, relatively near term, relative certain, relatively quantifiable are thing that could be disclosed. [Also included in 10(c)] **[TC 2/2, p. 33]**

Participant C-11
Talking about the specific examples in the meeting materials, some of them very good, where there could well be a near term quantifiable change occurring because of certain items. I

think, ultimately, the preparer has a responsibility to understand and determine what those elements might be. An interesting subject here, is to what extent does the auditors also have responsibility to ascertain and know whether the management has properly identified quantifiable near-term things that could happen, that would have an impact on the various financial statements? [Also included in 17(b)] **[TC 2/2, p. 35]**

Committee/Staff/Observer
If we try and address the cost issue by saying that disclosure should be made of things that management does not have to incur special work to look for; is that an appropriate approach for disclosures? Does that make any sense? **[TC 2/2, p. 35]**

Participant C-13
How far did you look? **[TC 2/2, p. 35]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 13—Definition of Operating Opportunities and Risks and Relative Importance of Each

The Special Committee has defined operating opportunities and risks as follows:

Operating opportunities and risks are beneficial or detrimental circumstances in which a company is involved at the reporting date that are not its assets or liabilities but that may cause the reporting entity to have increases or decreases in cash flows in the future.

With respect to the foregoing proposed definition of operating opportunities and risks, please indicate your agreement or disagreement with the following:

SA Strongly Agree
A Agree
N Neutral
D Disagree
SD Strongly Disagree

	SA	A	N	D	SD
For public companies, *Management's Discussion and Analysis is a better location* for disclosures of opportunities and risks than the financial statement footnotes.	7	5	2		
Any required disclosure of operating opportunities and risks should be balanced with *considerations of the costs* of providing and auditing such disclosures.	7	6	1		

Disclosure of operating opportunities and risks should *focus on specific, clear identifications of near-term events and circumstances* rather than discuss unspecified possibilities.

SA	A	N	D	SD
11	3			

Disclosure of operating opportunities and risks should be *specific to the company* rather than address risks generally knows to be associated with the industry.

SA	A	N	D	SD
3	4	4	3	

Identification, rather than interpretation, should be the primary disclosure goal for operating opportunities and risks.

SA	A	N	D	SD
4	8	1	1	

Participant C-18: Identification, rather than interpretation, or measurement or estimates should be the primary disclosure goal for operating opportunities and risks.

A requirement to disclose operating opportunities and risks should be worded in a way that the *list of potential matters to be considered for disclosure* by the preparer and auditor is also known to the users of the financial report.

SA	A	N	D	SD
1	5	4	3	1

Participant C-18: Disclose what you didn't disclose? Reason needs to prevail here.

[PMQC 2/2, p. 23-24]

QUESTION 14—Kinds of Operating Opportunities and Risks About Which Information May Be Disclosed

The following are examples of operating opportunities and risks about which information might be disclosed in external reporting.

Please mark each to indicate whether you would **I—Include** or **E—Exclude** it in a disclosure requirement:

Operating opportunities and risks related to *sensitivity to*

___I-12,E-1 Interest rates
___I-13,E-1 Exchange rates
___I-8,E-6 Inflation

Participant C-11: Depending on circumstances. For example, inflation would not be relevant for a large number of U.S. domestic companies.

Operating opportunities and risks *resulting from*

___I-6,E-7 Possibilities of new competitors
___I-8,E-6 Possibilities of substitute products

Participant C-13: Include only if probability is very high or certain.

___I-7,E-7 Changes in bargaining power of employees
___I-4,E-10Changes in bargaining power of customers
___I-12,E-2Changes in costs of producing products or services
___I-6,E-8 Changes in bargaining power of suppliers

Participant C-11: But a high-probability threshold should be used.

Participant C-12: First, third and fourth: No one is going to tell the truth in print about these three!

___I-14,E-0Large increases or decreases in proportion of products or services sold to one or two large customers
___I-12,E-2Large increases or decreases in proportion of materials purchased from one or two large suppliers
___I-13,E-1A growing inability to pay suppliers and lenders on time
___I-7,E-6 Possibilities of changes in the company's relative competitive position

___I-5 Other. Please describe

Participant C-17: Back logs and trend.

Participant C-3: Changes in government regulations.

Participant C-5: Product initiatives/Status/RTD

Participant C-4: Changes in risk management of insurance issues with compensation and probability/liability. Disclose increasing in self insurance.

Participant C-17: Unfunded construction projects and cost.

Participant C-3: Changes in consumer demands.

Participant C-5: Changes in product mix, new releases.

Participant C-4: Possible environmental liabilities from purchase of property, etc.

Participant C-17: Capital exp. budget (annual).

Participant C-5: Changes in employee/union contracts.

Participant C-17: Pending acquisition or sale of assets.

Participant C-11: Judgement is critical to decisions on risk and uncertainty and this cannot be standardized. There is risk in all business activities. If disclosures are made, they must be specific to the company, and represent material and identifiable circumstances. For many of these the MD&A is by far the most appropriate plea for disclosure.

[PMQC 2/2, p. 24-25]

[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 disclosure about operating opportunities and risks.

Participant C-15
I'll go with number 11 (core earnings) as my first choice. And 13 (financial instruments) is my second choice. [W]e always ask the questions and we meet with financial institutions and increasingly with industrial companies and so on about their off-balance-sheet financing, in particular swaps and other types of instruments. And I think that we find at the senior management level, CFO level, that we deal with that they broadly understand the issues. But when it comes down to getting into specifics, they say that they have somebody locked away in a corner room someplace who is really doing all this work. Something going forward which I think is going to be increasingly important are these environmental liabilities (number 14). They're kind of difficult to get your hands around but these are the types of things, if you look at a company like [name deleted] for example, that just came out of the clear blue. You looked at their balance sheet and income statement, you didn't have a hint anything was wrong with the company. Well, you knew something was wrong by reading the footnotes that they had these asbestos related liabilities but the next thing they're on their way over to bankruptcy court. I think that disclosure of those types of liabilities going forward is going to be increasingly important. [Also included in 15 and 19] **[TC 3/11, p. 70-71]**

[Context] Responses to the postmeeting questionnaire of the December 9, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 19 - Definition of Operating Opportunities and Risks and Relative Importance of Each

b. Is information about risk more important to you than information about opportunities? Please answer by indicating your ranking of the following with 1 meaning most preferred, 2 meaning next preferred, and 3 meaning least preferred *(use a number only once)*

10(b). Types of Opportunities and Risks That Should be Disclosed–Page 17

	Most preferred	Next preferred	Least preferred
Investors' and analysts' needs for information about opportunities and information about risk are roughly equal	*1*	*5*	
Investors and analysts need more information about opportunities than about risks because (please describe)			*6*
Investors and analysts need more information about risks than about opportunities because (please check as many as are appropriate)	*5*	*1*	
• Warnings of probable unfavorable changes in assets and liabilities and profits are more necessary than messages of probable favorable changes	*4*		
• Companies already have a propensity to talk a lot about opportunities but to withhold information about risks	*5*		
• Other. Please explain *Participant I-12*: Fiduciaries are interested in preserving capital and must assess the risk of loss in their investment decisions. Lenders (both loans and debt) are concerned about getting repaid interest and principal. *Participant I-9*: I do not think that this section is a fruitful area for accountants to get into. It is the job of the analyst to ask the right questions of management on risks and opportunities based on the knowledge of the company, the industry, and trends in competition, etc. Accountants should stay away from this area, it is not their area of expertise.	*1*		

[PMQI 12/9 and 1/13, p. 38-39]

QUESTION 21 – Kinds of Operating Opportunities and Risks About Which Useful Information May Be Disclosed

The following are examples of operating opportunities and risks about which information might be disclosed in external reporting. Please mark each to indicate whether you would I—Include or E—Exclude it in a requirement to disclose information about operating opportunities and risks facing a company:

	Include	Exclude
Operating opportunities and risks related to volatility of:		
• Interest rates	*6*	*1*
• Exchange rates	*7*	
• Inflation *Participant I-12*: unless a company has a very specific, direct exposure to inclation/deflation alone	*2*	*4*
Operating opportunities and risks resulting from:		
• Possibilities of new competitors	*4*	*2*
• Possibilities of substitute products	*5*	*2*
• Changes in bargaining power of employees *Participant I-11*: Exclude or include depending on facts and circumstances	*4*	*2*
• Changes in bargaining power of customers *Participant I-11*: Exclude or include depending on facts and circumstances	*4*	*2*
• Changes in costs of producing products or services	*7*	
• Changes in bargaining power of suppliers *Participant I-11*: Exclude or include depending on facts and circumstances	*3*	*3*
	Include	Exclude
• Large increases or decreases in proportion of products or services sold to one or two large customers	*7*	
• Large increases or decreases in proportion of materials purchased from one or two large suppliers	*7*	
• A growing inability to pay suppliers and lenders on time *Participant I-12*: When would this be insider information?	*7*	
• Possibilities of changes in the company's relative competitive position	*4*	*2*
• Other. Please describe		

[PMQI 12/9 and 1/13, p. 42-43]

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), 4, 11(a), and 15] **[KPMG BANK STUDY, p. A-9]**

- **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), 4, and 15] **[KPMG BANK STUDY, p. A-13]**

  [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 4 and 15] **[KPMG BANK STUDY, p. A-13]**

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), 1(c), 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), 1(c), 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), 1(c), 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), 1(c), 10(d), and 13] **[S&P, p. 16]**

Limited credit will be given if the various lines of business react similarly to economic cycles. For example, diversification from nickel into copper cannot be expected to stabilize performance; similar risk factors are associated with both metals. **[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), 1(c), 10(d), and 13] **[S&P, p. 16]**

10(c). Content of Disclosures About Opportunities and Risks

"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. Individual [investors] 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 1(b)] **[SRI, p. 31-32]**

[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.

Committee/Staff/Observer
Is it possible, [participant I-12], that some kind of a sensitivity analysis, or a stress test, on those instruments [derivatives] would be more meaningful in terms of how they move in relation to interest rate changes and how they are related to the instruments they're linked to? [Also included in 10(b) and 19] **[TI 1/13, p. 51]**

Participant I-12
I think that something along those lines could be very useful. There are people who are using those instruments who I suspect haven't the foggiest notion of what they've got. There is a lot of work that needs to be done. [Also included in 10(b) and 19] **[TI 1/13, p. 51]**

[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, a comment was made on the disclosure of operating opportunities and risks.

Participant I-16
If I own 100% of a business and I had somebody running it, I would ask to see his plans for the coming year. I understand that for a company with 1 million shareholders, you're not going to put out that kind of detail. But giving some indication of what you anticipate being able to accomplish in the future, the obstacles that you have to overcome, and the opportunities that you pursue, I think management should be encouraged to provide broad guidelines on that. And I don't think they should be encumbered by the auditors in that regard. I think that's between management and shareholders and I don't think the auditor has a role in that. If the auditor did have a role, it would dampen the explicitiveness of what management is saying; you don't want boilerplate, you want something that is meaningful. [Also included in 12 and 17(c)] **[TI 3/17, p. 17]**

[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.

Participant C-15
Has there any thought been given to how specific these types of disclosures would have to be? The way it's worded, it's difficult to see, if I were to write it and discuss something like this, where you would go with it. **[TC 2/2, p. 30]**

Committee/Staff/Observer
From a user perspective, though, I think you would want detail? **[TC 2/2, p. 30]**

Participant C-15
Sure. **[TC 2/2, p. 30]**

Participant C-14
I concur with everyone's comments regarding this area but I don't want to throw out the baby with the bath water. [Participant C-5] brought a point earlier about sensitivity analysis of changes in commodity prices; those are quantifiable risks and that's valuable information. **[TC 2/2, p. 31]**

Participant C-5
It's not a forecast, it's a plus/minus indicator. It can go either way. This is really giving me detail on historical numbers. So it very much is to me a kind of sensitivity analysis as opposed to forecasting, the difference between the two. Sensitivity is plus/minus, forecasting is I know which way it's going and here's what's going to happen. **[TC 2/2, p. 31]**

Participant C-5
Just another example of the situation at [name deleted]. I have a lease expiring in 1994. It's nice they show you that, but they don't tell you that it's above market. It's above market by $26 and, therefore, I'd like you to have a reduction in my occupancy expense by this dollar amount. You know, the impact on future years' revenues, the future periods beyond that. There is a need for that. It just helps to build the historical financial statements; you're looking at the past to predict the future. And right now, we don't get that sort of flow from the historical forward as much as we should. [Also included in 10(b)] **[TC 2/2, p. 32-33]**

Committee/Staff/Observer
Let me take what you were just saying and get you to focus on the bullets that are particularly at the bottom of page 18 and top of 19 of the meeting materials. Going back to what [committee/staff/observer] was talking about in terms of who prepares the financial statements versus who attests to them, we recognize that those lines frequently are blurred particularly in the private small business area. But, for the moment, if we could focus on preparer. I assume that, as [participant C-5]'s talking about, you don't have MD&A. You somehow probe and get this information some other way if it's important. How do you get it? **[TC 2/2, p. 33]**

Participant C-7
You use the financials as a starting point, it raises questions where you then go back to management. **[TC 2/2, p. 33]**

Participant C-11
I think we can repeat the words that we've been saying all the way through here. And that is, relatively near term, relative certain, relatively quantifiable are thing that could be disclosed. [Also included in 10(b)] **[TC 2/2, p. 33]**

Participant C-7
To some extent, I think a lot of the small local practitioner firms will have to step in and hold the client's hand and walk them through these types of disclosures and, how long does that add to the reporting cycle, what's that add to the customer's cost? **[TC 2/2, p. 33]**

Participant C-2
That's a real concern I think for the small banks, small business. We're seeing already a dramatic trend from audited to reviewed and even more so to compiled statements now with no disclosures because of this, I'm sure. [Also included in 17(e)] **[TC 2/2, p. 33]**

Participant C-15
A lot of this information we obtained by meeting with the management of the company and asking questions about it. But, in terms of a level playing field, an individual investor, for example, may not have the opportunity to do that; there's a balance in there somewhere I guess. **[TC 2/2, p. 33-34]**

Committee/Staff/Observer
So in looking for the balance to be struck, what is your view? **[TC 2/2, p. 34]**

Participant C-15
I'm not quite sure what the answer is. I think somewhat less than it's mentioned over here, but maybe little bit more than we get out, I guess that's not a good answer. **[TC 2/2, p. 34]**

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 2(d)] **[TC 2/2, p. 34]**

Participant C-2
I wanted to ask you a question about the concept of field testing. Has there really been any thought to field testing these issues to determine what kinds of additional costs are going to be required to develop a range of disclosures and then how useful they actually turn out to be? **[TC 2/2, p. 34]**

Committee/Staff/Observer
There is another group of folks (AICPA) who are working on a disclosure proposal for risks and uncertainties. While it uses the same words and at times uses the same notions, it is a different proposal. It makes different slice of things and it is true that they are well ahead of

what the committee that's working on this proposal is doing and that, as I understand it, there is a notion of field testing built into their process after it's being put out for exposure. **[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 2(d)] **[TC 2/2, p. 34]**

[Context] Responses to the postmeeting questionnaire of the December 12, 1992 and January 13, 1993 Investor Discussion Group meetings.

QUESTION 20 - Thoughts on Disclosure Principles

The Committee is considering whether or not external reporting could usefully include systematic disclosure of information about operating opportunities and risks facing a company, a question whose answer depends significantly on whether or not your present sources of that kind of information are adequate. We understand that investors and analysts get information about a company's operating opportunities and risks from a variety of sources, including discussions with the company's management, customers, suppliers, and competitors; industry trade publications; and various publications and documents that describe or discuss political, regulatory, social, technological, and economic trends that could affect the company. The SEC's MD&A (the subject of Question 22) also is at least to some extent a present source of that kind of information.

a. Do your current sources provide adequate information about operating opportunities and risks facing a company?

Yes *1*	*No* *5*

Participant I-9: See answer above.

b. Regardless of how you answered Question 20(a), please indicate whether you S—Strongly Agree, A—Agree, or D—Disagree with each of the following:

Rank S, A, or D

	Strongly agree	Agree	Disagree
For public companies, Management's Discussion and Analysis or something similar is a better location for disclosing information about operating opportunities and risks than the notes to financial statements	*4*	*2*	*1*
A requirement to disclose information about operating opportunities and risks should be balanced by considerations of the costs of providing and auditing the information disclosed *Participant I-12*: as well as the proprietary nature of such disclosure- like new products or technological break-throughs	*4*	*1*	*2*
Requirements to disclose information about operating opportunities and risks should focus on opportunities and risks:			
• That result from specific, clearly identifiable, near-term events and circumstances rather than those that might result from unspecified events and circumstances in the distant future	*6*	*1*	
• That have a reasonable chance of occurring rather than those that do not	*3*	*4*	

	Most preferred	Next preferred	Least preferred
• That are likely to affect shorter-term cash flows rather than those that are likely to affect longer-term cash flows	*2*	*4*	*1*
• That the company is currently exposed to rather than those that might develop wholly in the future	*4*	*3*	
• That management has already identified or should have identified rather than those that would require a special search by management	*2*	*3*	*1*
• That are specific to the company or to which the company is unusually exposed rather than those generally known to be associated with the company's industry	*2*	*3*	*2*
Identification, rather than interpretation, should be the primary goal for disclosure of information about operating opportunities and risks	*2*	*1*	*3*

[PMQI 12/9 and 1/13, p. 39-41]

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), 3(e), 5(b), 13, and 17(f)] **[KPMG BANK STUDY, p. 38]**

- Expanded disclosures of the allowance for loan losses [Also included in 5(b)] **[KPMG BANK STUDY, p. 39]**

- Management discussion of asset/liability management and credit quality [Also included in 13] **[KPMG BANK STUDY, p. A-39]**

10(d). Other

[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), 1(c), and partly included in 17(f)] **[PREVITS, p. 12]**

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 1(c)] **[PREVITS, p. 16]**

[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 operating opportunities and risks.

Participant I-12
One of the things that worries me is, 5-7 years ago, there was a company that had a 15% interest in some subsidiary but it basically pledged its balance sheet and its full resources to that subsidiary and ended up going bankrupt because of a problem in this minority-owned operation. In general, that's a rare instance because there are usually enough other factors that we would see. But I think that kind of situation, instances where the whole company is at stake, needs to be revealed. [Also included in 6] **[TI 12/9, p. 39-40]**

Participant I-8
There is a current disclosure requirement on contingent liabilities; I would think that situation would be covered. [Also included in 6] **[TI 12/9, p. 40]**

Committee/Staff/Observer
It's hard for me to believe that if the investor company had somehow signed its life away and had this contingency, that there wouldn't be some disclosure. [Also included in 6] **[TI 12/9, p. 40]**

Participant I-6
I can tell you something very current about contingent liabilities, which is environmental related. There is a small mining company that has been buying coal from another small private company; that company walked away from its land reclamation responsibility. The public company upstream was forced to step in and assume the other company's reclamation costs because they bought the coal from them. That's a very real contingent liability that is not disclosed any place. **[TI 12/9, p. 40]**

[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.

Participant I-7
My first source is the competition, the second source is the customer, and the third source is the company itself. Industry trade groups are also a source. **[TI 1/13, p. 43]**

Committee/Staff/Observer
Is my impression correct that financial statements are low on the list of sources of information about operating opportunities and risks? **[TI 1/13, p. 44]**

Participant I-14
Yes and no. Someone whose adding 50% to their plant account, that's a big statement. **[TI 1/13, p. 44]**

Participant I-11
Financial statements can give you information about the company's ability to exploit opportunities and to absorb the risk, but financial statements are historical events and we're talking about prospective occurrences. **[TI 1/13, p. 44]**

Participant I-8
Financial statements form the basis to ask questions about the future. **[TI 1/13, p. 44]**

Participant I-7
I agree with [participant I-8]. If you're going out to visit a company, you look at the financial statements first. **[TI 1/13, p. 44]**

Participant I-12
We get quite a bit on risks and opportunities in a lot of the SEC documents. There is a big section in the K talking about the underlying business; it almost parallels what you see in a prospectus. You get a lot of information in prospectuses as well. [Also included in 10(b)] **[TI 1/13, p. 46]**

Participant I-7
I found those statements being nothing more, for the most part, than disclaimers. Management knows quite well what the risks are; we should get more of that information in detailed form rather than just broad disclaimers. [Also included in 10(b)] **[TI 1/13, p. 46]**

Committee/Staff/Observer
[Participant I-11], is your willingness to accept current practice [for disclosure about operating opportunities and risks] in part a function of your good knowledge of your industry and your ability to get the information through talking to various sources? Would you be willing to accept current practice if you didn't have access to those sources? [Also included in 10(b)] **[TI 1/13, p. 57]**

Participant I-11
I can't answer that question; I don't know. I'm in the business of getting that kind of information, I don't know how I would react otherwise. [Also included in 10(b)] **[TI 1/13, p. 58]**

Participant I-12
A lot of that information is available to people outside our profession through things like Investment Dealers Digest or some of these newsletters that go out, the business press, etc. It seems to me that a lot of the things that we see as analysts and portfolio managers are increasingly available to the general public. [Also included in 10(b)] **[TI 1/13, p. 58]**

Participant I-7
That's a very interesting question. How far does your profession want to reach? If it wants to reach the person in Dubuque, maybe the next discussion session should be with those people to get an answer. I don't know if we're the best people to answer the question. **[TI 1/13, p. 58]**

Participant I-8
I don't think you want to run the risk of contaminating everything you do with something that you really can't do. This whole effort is to make financial reporting better and you run the risk, if you're trying to tackle something that you just can't do, that it reflects poorly on the rest of your effort. **[TI 1/13, p. 58]**

Participant I-14
I would ask again that, in your capacity as advisors to corporations, you encourage companies to be a little more candid in responding to these things. That would be an enormous help. **[TI 1/13, p. 58]**

[Context] Responses to the postmeeting questionnaire of the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 15—Management's Discussion & Analysis (MD&A) [Also included in 13]

We recognize that private companies do not provide MD&A's, at least not according to a regulatory requirement. Consequently, creditors lending principally to private companies may have limited concerns or opinions regarding the SEC-required MD&A disclosures. *If you serve private companies, please pay particular attention to item (d) below.*

For public companies, the discussion at the meeting left the Committee with the impression that some members of the group felt that improvements could be made in implementing current MD&A requirements.

a. Current MD&A disclosures in annual reports generally fall short of user expectations.

_ AGREE 11 _ DISAGREE 3

Participant C-2: Neutral, depends on quality and candor of report.

If AGREE, please indicate your view of the following (SA - Strongly Agree, A - Agree or D - Disagree):

___SA-2,A-5,D-3 Current MD&A's tend to use too much cautious legal language instead of straight-forward descriptions of the pertinent events, circumstances, trends, commitments, and uncertainties that are likely to make the company's future different from its past.

___SA-2,A-8,D-1 Current MD&A's tend to repeat the same descriptions from period to period, merely changing the numbers instead of focusing on events, opportunities and risks which may be new in a particular period.

___SA-1,A-6,D-4 Current MD&A's tend to overemphasize opportunities and remain mostly silent about potential risks.

___ Other. Please describe

Participant C-14: Lack of specific discussion on cooperative strategy and alternative financial objectives.

Participant C-11: Lawyers and bureaucrats are the enemy. Rather than just repeating the numbers, the MD&A should provide an analysis of events in the period - written from the CFO perspective. This is not something that AICPA or anyone else can legislate.

Participant C-15: Because of legal liabilities resulting from these disclosures, e.g., CAT, these should improve over time but lawyers will have greater impact.

b. The MD&A provides a starting point for disclosing needed information about a company's operating opportunities and risks but the MD&A rules need to be changed to overcome the kinds of weaknesses described in (a) above

_ AGREE 6 _ DISAGREE 7

If AGREE, please describe briefly the major improvements needed:

Participant C-3: I think the media rules on "forward looking" disclosures need to be made more specific. Also, promulgating MD & A rules as part of GAAP (rather than SEC disclosures) would draw more attention to the issue and likely enhance the quality of disclosure.

Participant C-18: You cannot analyze a business from its F/S alone; you must meet management, observe operations, talk with customers/suppliers, and so on. We can't expect F/S to do all that for us; there is no way to replace the human instinct factor in this process.

Participant C-13: The current rules are adequate <u>if followed</u>.

10(d). **Other--Page 5**

Participant C-4: I believe MDA is too general, typically included in annual report and only referred to in 10k. Much too general presentation. Need specifics, would prefer precise, sequential, consistent disclosure.

Participant C-7: There should be recognition of the speculative nature of such commentary.

Participant C-12: MD&A focuses mostly on an explanation of current financial statements, not on opportunities or risks that will effect next year's statements.

Participant C-15: Greater discussion of factor effecting results. Should be less legislative.

c. The MD&A generally provides needed information about a company's operating opportunities and risks and should be incorporated comprehensively into external financial rules rather than being part of a separate regulation.

_ AGREE 8 _ DISAGREE 5

Participant C-13: Impossible to construct rules which would cover every conceivable situation. Doing so would accelerate use of "legalese."

Participant C-11: Does "external financial rules" mean AICPA - If so, I disagree. The MD&A should be written from a broad, operating business prospective, with the same perspective if not the detail that would be given to the Board of Directors. With all due respect, this is a broader focus than is represented at this time by the accounting profession.

d. From time to time, users have proposed that *private companies* should provide disclosures similar to MD&A. Please indicate your reactions to the following using:

SA Strongly Agree
A Agree
N Neutral
D Disagree
SD Strongly Disagree

MD&A disclosures for private companies would significantly improve their financial reporting.

SA	A	N	D	SD
4	6	1	1	

Participant C-18: It would be a joke. You would never again see an audited financial statement.

While MD&A disclosures for private companies would be desirable, the costs of providing the information would be of greater concern than the value of receiving the information.

SA	A	N	D	SD
4	1	2	2	1

Participant C-2: What is the cost typically? Hard to judge...

	SA	A	N	D	SD
If MD&A disclosures are provided by private companies, the detailed disclosure requirements should be the same as those for public companies.	3	4		4	2

Comments

Participant C-17: I believe it would be helpful but the cost would drive too many away. Direct access to the customer would allow each creditor to seek their own level of disclosure.

Participant C-13: I do not deal with private companies. My assumption is that private companies, in order to get financing, provide investors and creditors with more information in a discussion mode, than public companies.

Participant C-2: MD&A disclosures raise issues that might not automatically come to a lender's attention. Then the lender can seek out additional information. Would be particularly valuable in evaluating a new borrower.

Participant C-4: Standardizing MD&A reporting can provide a basis for further discussion with management of private companies. It would also provide a framework of required disclosure that could be useful in comparative analysis.

Participant C-14: Probably a useful exercise for management.

Participant C-11: I defer to other panelists in general. However, the term "private company" is misleading. We have some private placement investments where the companies are large enough so that we can insist that an MD&A - type discussion is justified.

[PMQC 2/2, p. 26-29]

[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 disclosure about operating opportunities and risks.

Participant C-14
There's really just two opinions, you're either clean or you're not clean. And I'm not sure how that's done but if I could add one sentence to the opinion it would be: the major risks to the reported net worth of the company are the following... And there's three blanks and you guys fill in the blanks. And that would give you an opportunity to highlight whether it's an off balance sheet item, whether it's inventory controls, whatever it is. And if every statement had that, auditors would have the leverage with management to fill in those blanks. [Also included in 17(c)] **[TC 3/11, p. 30]**

Committee/Staff/Observer
This would be an assertion the auditor would make as opposed to the management saying the three risks we believe the company is at risk in? [Also included in 17(c)] **[TC 3/11, p. 30]**

Participant C-14
You would fill in those blanks. It would be the three major risks on the stated net worth based on our opinion of the reliability of the accounting or validity of the values in the accounts are the following: ... But it's got to be practiced industry-wide or you'd have no leverage over management to get them in your opinion. That's an ideal world. But that's the kind of quality of information that could be in an opinion. [Also included in 17(c)] **[TC 3/11, p. 30]**

Participant C-5
Would they be sized? [Also included in 17(c)] **[TC 3/11, p. 30]**

Participant C-17
And then you start getting into what's the probability and so on. [Also included in 17(c)] **[TC 3/11, p. 30]**

Participant C-14
It's not to go and say that these negative things are going to occur, it's just to highlight them as large potential areas for concern; maybe they are areas where you couldn't come up with a hard value. You can't come up with a hard value on legal liabilities or environmental liabilities. But you may in your audit work determine that the degree of variation of potential outcomes is so great that it should be mentioned as a very viable risk. I don't know about size threshold. I'm just throwing out a very idealistic concept. [Also included in 17(c)] **[TC 3/11, p. 31]**

Participant C-12
Being more of a cynic than an idealist, I throw out the idea that advocating a less standardized approach, given the business and legal environments in which we all work and the realities of the marketplace, it's going to be difficult to say certain things, both in terms of what management will accept in terms of the business relationship and particularly in terms of what the lawyers are going to allow to be said. And I fear that in the end it's a good idea. What we get is boilerplate; we think we have information but what we have is boilerplate. [Also included in 17(c) and 18(b)] **[TC 3/11, p. 31-32]**

Committee/Staff/Observer
With that cynical view, then would you just advocate staying where we are? [Also included in 17(c) and 18(b)] **[TC 3/11, p. 32]**

Participant C-12
I would tend to, yes, because I think in the end if we try to broaden what we get, the lawyers and the business relationship is going to give us boilerplate. [Also included in 17(c) and 18(b)] **[TC 3/11, p. 32]**

Participant C-14

Why would it necessarily be boilerplate? Are you saying that every opinion would have the same three issues? Or that because of pressure from management they'd pick issues that aren't truly significant? [Also included in 17(c) and 18(b)] **[TC 3/11, p. 32]**

Participant C-12
I tend to think we'd get the three easy ones raised in a way that waters them down a lot. We've been through this with merger letters and we've seen them expanded greatly. But there's no additional information there. There's more stuff but there's no useful information in this greatly expanded letter. Because the lawyers get hold of it. [Also included in 17(c) and 18(b)] **[TC 3/11, p. 32]**

Participant C-17
It tends to violate the two things I hold dear. One is the independence issue and the other's the consistency. When you start trying to do the hit list for the year and you have some kind of predetermined format, it just becomes subject to all kinds of constraints from the legal end or boilerplate; it tends to have very little value when it comes out. [Also included in 17(c) and 18(b)] **[TC 3/11, p. 32]**

Participant C-5
I'm not losing that much in that standard letter; it's boilerplate to the max with the exception of your qualification of the opinion and then the listing of the items that are material in your qualification. As to the issue that [participant C-14] raised about business risks, I want the company's specific risks or those that are unique or different from that which someone would expect for the industry it's in. If I'm in the dry cleaning business and I run 500 laundries, we all know they've got environmental risks and now it's up to me to make a determination of how much they are. I really would only want it if it's a unique risk for that particular company. It may not be the largest risk, in fact, it may be the one that's least risky where I've already assumed there's high risk because of the industry component that it's in. I don't need an auditor to take publicly available information and long perspectives and opinions that are published through analysts and industry watchers and so forth and give that back to me again. In some cases, you have to assume you have no idea who the user is because there's broad distribution of financial statements, but there are other cases where you can be very specific as to what the issues are for the user of the financial information. [Also included in 17(c)] **[TC 3/11, p. 33-34]**

Participant C-12
In general I like [participant C-14]'s idea although if it's going to work we've got to be closer to the ideal than the cynic's view. I'm basically a cynic and I think the risk is that we end up with something extra that looks like more information but isn't. I like the boilerplate we have now which comes down to basically a very important binary decision, qualified or unqualified. One change I would like to see in the letter though is just a listing of how important the business relationship is. You're telling me you've done the work, tell me how biased or unbiased you are. [Also included in 17(c)] **[TC 3/11, p. 34]**

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 4] **[KPMG BANK STUDY, p. A-16]**

- **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 1(c)] **[KPMG BANK STUDY, p. A-17]**

10(d). Other--Page 10

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.

10(d). Other--Page 11

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 1(c)] **[KPMG BANK STUDY, p. A-17, A-18, and A-19]**

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 1(c)] **[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), 1(c), 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 1(c)] **[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), 1(c), 10(b), and 13] **[S&P, p. 16]**

The basis for competition determines which factors are analyzed for a given company. [Also included in 1(b), 1(c), 10(b), 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), 1(c), 10(b), 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), 1(c), 10(b), and 13] **[S&P, p. 16]**

Most critical is a company's ability to manage diverse operations. Skills and practices needed to run a business differ greatly among industries, not to mention the challenge posed by participation in several different industries. For example, in the rush to diversify into financial services, a number of companies entered unfamiliar businesses they had difficulty managing. **[S&P, p. 16]**

10(d). Other--Page 13

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), 1(c), 10(b), and 13] **[S&P, p. 16]**

11. Interim 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	□

11(a). Frequency of Interim Reporting

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(c), and 3(d)] **[PREVITS, p. 21]**

Frequency of Reporting
In the United States, publicly owned companies are required to report quarterly on Form 10-Q filings with the Securities and Exchange Commission. Exchange regulations require listed firms to send quarterly reports directly to shareholders. Private companies also tend to report quarterly to their creditors and other financial statement users. In most other countries financial reports are issued semi-annually; in a few countries, only annual reporting is the norm. Some people now advocate that the United States abolish its quarterly reporting requirement and regress to semi-annual or even annual reporting only. [Also included in 18(a)] **[AIMR/FAPC92, p. 13]**

The membership of AIMR unequivocally supports quarterly financial reporting and is absolutely opposed to any movement to eliminate it. Our arguments on that subject appear in more detail later in this report. At this point, we wish merely to point out that some of the impetus for the eradication of quarterly reporting results from the phenomenon of globalization. We believe that financial markets, both domestic and foreign, are best served by frequent and even-handed dissemination of information to the public. We urge the Congress of the United States, the SEC, and its international counterpart, IOSCO, to heed the admonitions later in this report on the subject of quarterly reporting. [Also included in 18(a)] **[AIMR/FAPC92, p. 13]**

Timeliness
Although Statement of Financial Accounting Concepts No. 2 categorizes timeliness as a subset of relevance, it has an importance to analysts that merits attention of its own. As we argue above, financial information is useful only when it is disseminated quickly, fairly and widely because the digestion of such information by analysts is what makes markets efficient. In the United States and Canada, this has been embodied in the practice of companies issuing financial statements quarterly supplemented by press releases and Form 8-K disclosures for important events occurring between reports. **[AIMR/FAPC92, p. 22]**

Recently there has been vocal criticism of the practice of quarterly financial reporting. It has been accused of causing managers of American businesses to focus on short-term results and of neglecting those activities whose worth would be greater over a longer time. Investors have been blamed for calling portfolio managers to account for their quarterly performances and portfolio managers for responding to them. **[AIMR/FAPC92, p. 22]**

Ironically, the financial markets are increasingly influenced by the investment activities of pension trusts, whose corporate sponsors are managed by the same persons who protest that frequent interim reports force them to manage for the short term. Also, it is unlikely that rational investors will punish a firm for undertaking projects that promise extraordinary long-term payoffs as long as that firm is willing and able to communicate to those investors its strategy and tactics. **[AIMR/FAPC92, p. 22]**

A further irony is that business managers themselves often are compensated or otherwise rewarded for short-term performance, measured either by accounting numbers or by the market performance of their employer's securities. Relief from so-called "short termism" is more likely to be successfully effected through changes in corporate governance, including fundamental and radical changes in the paradigm used to reward certain executives, than by abolishing one of the most important sources of analytic information available. **[AIMR/FAPC92, p. 22]**

A collateral benefit of frequent financial reporting is that it diminishes opportunities for trading on privileged information, a practice all responsible members of the investment community deplore. The longer a company waits to release information to the public the more likely it is that the information will become known sooner to a small and select group that can use it to trade for its own benefit. Even under current disclosure rules, which many find draconian, financial information has from time to time been intercepted or diverted on its way to dissemination. **[AIMR/FAPC92, p. 23]**

[Context] The following brief summary of the topic "Financial Statement Dissemination," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

In recent years mandated quarterly reporting in the United States has come under increasing attack. Many charges have been leveled, most recently that it leads to "short-termism" and that it causes the U.S. to lack competitiveness with the rest of the world, in which reports usually are issued only semi-annually. We feel strongly that these charges are wrong and this section provides an exposition of the virtues of quarterly reporting, refutation of the arguments against it, and an initial argument for disaggregated quarterly information (quarterly segment reporting). **[AIMR/FAPC92, p. viii]**

Obviously, financial markets and financial analysis thrive on information. Furthermore, information will eventually find its way to influence market prices, whether the avenues it takes are legitimate or not. As investment professionals who take pride in our ethical conduct, we need to have information that is frequent, reliable and relevant. We need to have it disseminated even-handedly so that it becomes available to all market participants at the same time, rather than first to the privileged few. We believe the arguments against quarterly reporting are specious and we give substantial reasons to support that opinion. **[AIMR/FAPC92, p. 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.

Financial analysis thrives on information. There is an extended discussion earlier in this report of the various and sundry information sources employed by financial analysts and investment managers [included in 1(b)]. For capital allocation to proceed efficiently in our economy, information must be disseminated both promptly and publicly. This applies to financial information, both in the form of financial statements and otherwise, as well as to sources of all nonfinancial data that can affect perceptions of the value of companies. The two conditions, promptly and publicly, are complementary. As we explain below, if financial information is not disclosed to the public promptly it will become known first to a small number of privileged "insiders," only later filtering down to the public at large. Those circumstances place an onerous burden on AIMR members who are prohibited against the use of material nonpublic information by the AIMR Code of Ethics and Standards of Professional Conduct. [Footnote reference omitted.] **[AIMR/FAPC92, p. 34]**

The economic affairs of an enterprise should be reported in financial statement form at regular and frequent intervals. A year or six months is too long to wait for facts, either good or bad, to be disclosed formally. Less than three months is too short a period for most businesses to make meaningful measurements of economic activity; it also would require excessive periodic assessments of financial status. Thus quarterly interim reporting satisfies optimally the tradeoff between: (a) the maximum length of time an analyst should have to wait to receive a report on an enterprise's economic progress and status, versus (b) the minimum period of time for which meaningful financial measures can be made. **[AIMR/FAPC92, p. 35]**

Our comments on quarterly reporting herein have two different purposes. First, we wish to make clear and emphatic our unanimous opposition to recent movements by certain individuals and organizations to abolish mandatory quarterly reporting. Our case takes two forms: (a) substantiating the reasons why quarterly reports are vital to analysts and, perforce, for the efficient functioning of the capital markets; (b) showing why the arguments made for the eradication of mandated quarterly reporting are specious.[11] Second, we wish to explicate how quarterly financial reporting needs to and should be improved. [Also included in 11(c)] **[AIMR/FAPC92, p. 35]**

<u>Arguments Supporting Mandated Quarterly Reporting</u>

The most overwhelmingly important ground for retaining quarterly reporting requirements is that alluded to above, the efficient allocation of capital within the economy. To repeat, financial analysis thrives on information. The more quickly it is made available, the faster investment decisions may be made to direct capital to uses that will overall maximize economic welfare. The ideal state is one in which economic events and their consequences are made public as they occur. In fact, most significant economic events become public knowledge before they are reported in financial statements. Their consequences however are a matter of speculation and disagreement among analysts, much of it reasonable and rational but

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[11] The discussion of quarterly reporting in this paper is necessarily limited. For a more comprehensive presentation of analysts' views on the subject, see the following recent publication of AIMR's Financial Accounting Policy Committee: Donald Korn, CFA. *The Need for Quarterly Financial Reports from Publicly Owned Companies: A Response to the Competitiveness Debate*. Association for Management Investment and Research, 200 Park Avenue, 18th Floor, New York, NY 10166, 1992. (Single copies are available without charge upon written request.)

speculation nonetheless, until financial statements are released. Until that time uncertainty exists, carrying with it a concomitant increase in capital cost. **[AIMR/FAPC92, p. 35]**

Most economic events affecting business enterprises are individually small in relation to the overall economic progress and status of the firm. But they aggregate into numbers of material size. Quarterly reports are the early warning system of the investment world. Some persons have likened them to the mile markers on superhighways. Even though they are not as precise in measurement as mile markers, they at least tell us in what direction the enterprise is going and roughly how quickly it is proceeding. **[AIMR/FAPC92, p. 35]**

To analysts quarterly reports are not only indicators of progress and status to date, they also are important resources for projecting the future. A good part of a financial analyst's work involves making recommendations or engaging in transactions based on expectations of future economic performance. Many analysts are called upon to make formal and frequent estimates of future corporate earnings. Quarterly reports are vital, not as much for what they tell us about the past as to what they tell us about revising our expectations of the future. When a quarterly report contains a "surprise," there usually is an immediate reaction in that enterprise's stock price. The stock price change reflects a change in value not because the past turned out differently than expected, but because the market has promptly and alertly changed its expectations of the future. **[AIMR/FAPC92, p. 35-36]**

Deterrence of trading on privileged information is the second major argument in favor of mandated quarterly reporting. As noted above, the code of ethics by which we work as professional analysts prohibits us from trading on material nonpublic information and we pride ourselves on our observance of it. Adherence to that code is facilitated by the frequency with which information is made public. If information is withheld from the public by law, it still will be disseminated. The process will be slower and it will trickle down to the public through a host of privileged insiders and other informed persons who realistically could not be expected to refrain totally from trading on what they know and others do not. Any attempt to abolish mandated quarterly reporting might better be termed an effort to promote insider trading. **[AIMR/FAPC92, p. 36]**

Quarterly reports may be even more important to individual investors than they are to investment professionals. We have a large variety of public sources of information and we rely on them to confirm in an organized manner, our judgments and the fragmentary data on which they are based. For individual investors, public reports may well be and usually are their only source of reliable information. Those who choose to invest in free enterprise should not be denied the information to make those investments in the wisest and best informed manner not only in their own self-interest, but also with the result of improving economic society as a whole. **[AIMR/FAPC92, p. 36]**

<u>Rebuttal of Assertions Against Quarterly Reporting</u>

Much has been written about the evils of "short-termism" and its impact on management behavior. It is true that sometimes too much emphasis is placed on quarterly earnings reports. It is remarkable that some seemingly sensible people will make decisions based on insignificant deviations from expected earnings. On the other hand, it is quite appropriate for decision makers to revise their forecasts of the future based on new and recent information about the past. The point is that stock prices reflect expectations of the future only, and that past events do not change stock prices as such; they only change expectations. Too many companies have explicitly or implicitly promised consistent quarterly earnings gains; in return they have received premium price-earnings ratios. The need to achieve target earnings may result in inefficient management practices; in extreme cases it can result in accounting manipulation or even fraud. As long as a business enterprise keeps its investors informed of its strategies and plans, it has no reason to fear that its share price will suffer for devoting its resources to projects that promise high levels of long-term profitability. Those who contend otherwise either misunderstand or are misrepresenting the functioning of the investment community. **[AIMR/FAPC92, p. 36]**

Investors are not only every bit as interested in long-term results as business managers are, but probably even more so. Consider the respective sources of rewards to investment managers and business managements. Investment managers are rewarded for overall performance of investments vis-a-vis the market as a whole. Stock prices, as we have explained at length several places above, are a direct function of expectations of long-run future cash flows. Stock prices do not change because of quarterly past events; they change because of changes in long-run expectations of future events. By contrast, consider how many senior managers are compensated or otherwise rewarded for short-term performance, frequently measured by accounting numbers. **[AIMR/FAPC92, p. 36-37]**

As we stated earlier, "short termism" might better be dealt with by changes in the manner of corporate governance and executive compensation schemes, rather than by eradicating quarterly financial reporting, one of the most vital ingredients in rational and efficient capital allocation. Our system of continuous disclosure helps make markets efficient. Annual earnings have been shown to have limited effect on market prices; three quarterly earnings reports have taken much of the surprise element out. Reduced frequency of reporting would be likely to increase the volatility of securities prices around the time of earnings reports. **[AIMR/FAPC92, p. 37]**

Another argument against quarterly reporting is that in most other countries only semi-annual reports are required or traditional. Some persons believe that reporting requirements in the United States, of which mandated quarterly filings are only one, prevent foreign companies from listing their shares on exchanges here. They prophesy that the United States has been and will continue to lose stature among the world's capital markets. **[AIMR/FAPC92, p. 37]**

We disagree. No foreign company is prevented by quarterly reporting requirements from listing its shares here, although some may elect not to do so. Many foreign companies are registered in the United States and we cite, from among European companies, the exemplary conduct of Royal Dutch Petroleum Company. It has an active financial relations program in the United States and its quarterly earnings releases contain detail far beyond British, Dutch, IASC or even U.S. requirements. As long as capital exists those who need it will seek it out. **[AIMR/FAPC92, p. 37]**

The United States has the most highly developed and sophisticated systems of capital market regulation in the world. The Securities and Exchange Commission has an admirable record in endeavoring to protect investors, not from the consequences of their own actions, but from those who would take unfair advantage of them. The disclosure rules in general, and mandated quarterly reporting in particular, are an integral part of the system to protect investors and the free enterprise system itself. We must be vigilant against those who would subvert that system into promotion of particular market places. Markets exist to serve investors, not the reverse! **[AIMR/FAPC92, p. 37]**

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 included in 3(d)] **[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 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 included in 3(d)] **[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), 3(d), 4, 5(a), 8(c), 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), 4, 5(a), 8(c), 12, 18(a), 18(c) and 18(d)] **[AIMR/FAPC92, p. 60]**

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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.

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 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 1(d) and 3(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, a comment was made on the frequency of interim reporting.

> *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 5(a)] **[TI 10/16, p. 39]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting.

> *Committee/Staff/Observer*
> Other questions on interim reporting. May we safely conclude that you prefer quarterly reporting as opposed to monthly or semi-annually? Also, may we conclude that you prefer full

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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).]

interim financial statements as opposed to just disclosure of summarized interim data? [Also included in 11(c)] **[TI 3/17, p. 36]**

Participant I-11
I'd say yes to both. [Participant I-12] touched on a key element. The greatest opportunities for inappropriate valuations to occur in stocks is when there's a change of direction in the company's business. We all spend a lot of our time trying to identify times when a company's business is changing direction. It's a balancing act because there's a lot of static in the data. It seems to me that the quarterly financial report is a pretty good filter for that. If you get much shorter than a quarter, there's too much static. If you get much longer than a quarter, it's too late. Also, we all want full financial statements instead of summary information. [Also included in 11(c)] **[TI 3/17, p. 36-37]**

Participant I-7
Most of my manufacturing companies would say that 60% of their earnings would come in the third month of the quarter. So the first two months are useless. **[TI 3/17, p. 37]**

Participant I-12
I'd have a heart attack if I had to go through quarterly earnings on a monthly basis. **[TI 3/17, p. 37]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of interim reporting.

Committee/Staff/Observer
Question 11 deals with interim reporting. We presume that currently people prefer quarterly reporting as opposed to a move to more frequent reporting such as monthly. And we also presume that they prefer summarized information than the more detailed information, such as in the annual report. Those are items A and B on page 13 of the meeting materials. If someone has a belief that we have gotten that wrong from previous discussions, this would be a great time to register your complaint. [Also included in 11(c)] **[TC 3/11, p. 46]**

Participant C-13
It is of course common practice in many industries to report some items on a monthly basis -- sales, shipments, unit volume. Retailers come to mind particularly and automobile manufacturers. That's obviously useful disclosure and it's not a financial statement in any sense. But I wouldn't want any conclusion that the Committee comes to suggest that that's not an appropriate disclosure. **[TC 3/11, p. 47]**

Participant C-11
I think the most valuable starting point is quarterly. And then you can think about twelve months or something. But, quarterly is where you get your exceptions, your change in trend, your seasonality and so on. [Also included in 11(b)] **[TC 3/11, p. 48]**

Committee/Staff/Observer
I wanted to follow up on the quarterly notion. How far do you extend that? If the quarterly information is the most valuable of what you get, would monthly be more valuable? And if not, why is quarterly more valuable than annual? I'm trying to understand what's the magic about some three month period. **[TC 3/11, p. 49]**

Participant C-5
Could you imagine twelve month end sales rushes or volume rushes? Right now business runs on four quarter end volume rushes. **[TC 3/11, p. 49]**

Participant C-13
Our conclusion is that the best cost/benefit trade off from our point of view is quarterly. After all, we're the owners of the business, ultimately we're paying these costs. **[TC 3/11, p. 49]**

Participant C-11
I'll try to answer the question. The trend aspect is definitely important. And it's not just looking at an individual company and other similar companies but also with economic activity in general. And there are enough changes that can go on during the year where even semiannually does not capture the movement and aggregate economics as well as individual company things. My own experience has been that the limited number of situations where I've had monthly data is that there is as much noise coming from the internal accounting of the company itself. Certainly companies that have larger size items that they're selling, one or two sales can have an impact. So the answer you would probably tell me is that I'm used to quarterly and that's why I like it but it does seem to fit as best as anything can the reporting of industry and aggregate information. **[TC 3/11, p. 49]**

Participant C-17
I think [participant C-11] just said it, that quarter is a period that's got a link where you can establish a trend, either from the prior quarter or within the quarter and annually. I think you're right, it's also something we have become accustomed to and have been used to doing. **[TC 3/11, p. 50]**

Participant C-2
I think just having the staff to process the information would put a strain on our organization but secondarily, if we feel that we need monthly statements because of a particular concern with some aspect of the credit, we will get them and use them. Otherwise, we feel like we can go from quarter to quarter and, in some instances, frankly, all we get are annuals, generally where we're well secured. **[TC 3/11, p. 50]**

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 15

b. Is the optimum interim period for financial reporting (Please choose *ONE*):

<u>1</u> Monthly?
<u>12</u> Quarterly?
<u>0</u> Semiannually?
<u>0</u> Other? Please describe:_________________________

If *other than quarterly*, please explain why:

Participant C-14: But I believe there would be less securities price volatility and better creditor decisions if companies did report monthly revenue figures.

Participant C-21: Quarterly statements allow for too much time to go by without having any information. Again - size of company and loan would also dictate.
[PMQC 3/11, p. 23]

[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:

- Break-out of results for the seasonally important fourth quarter.
- Annual and quarterly release of divisional operating results.

[Also included in 15] **[AIMR/CIC91, p. 2]**

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 2(a), 15, and 16] **[AIMR/CIC92, p. 3]**

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), 5(d), 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), 2(c), and 16(b)] **[AIMR/CIC92, p. 3]**

Reserves must be analyzed [according to Picoult[1],]. 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 1(c)] **[AIMR FINSER INDUSTRY, p. 97]**

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), 4, 10(b), and 15] **[KPMG BANK STUDY, p. A-9]**

- **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 4 and 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 4 and 15] **[KPMG BANK STUDY, p. A-15]**

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[1] Myron M. Picoult, Managing Director, Senior Insurance Analyst, Oppenheimer & Company, Inc.

11(b). Periods Covered by Financial Statements

[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 cash flow statement display, comments were made on the periods covered by interim financial statements.

Participant I-5
I would like to get quarterly cash flow statements in 10-Qs, just for the three month period. [Also included in 5(c)] **[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 5(c)] **[TI 1/13, p. 41]**

Participant I-11
And the quarter should include the quarterly cash flow. [Also included in 5(c)] **[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 5(c)] **[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 5(c)] **[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.

Committee/Staff/Observer
Do you find useful the cumulative income and cash flow statement for the year to date and comparative statements for the preceding year that are required by the SEC? **[TI 3/17, p. 37]**

Participant I-12
I never use them because they don't add anything in terms of trend lines. Instead, I'll create a rolling twelve months, rolling four quarters for key numbers. But 6 months to 6 months, 9 months to 9 months, that doesn't add value for me in terms of turning points. A rolling 4 quarters or rolling 8 quarters gives me more information. **[TI 3/17, p. 37]**

Participant I-11
By the same token, getting just the cumulative cash flow statement in the interims is not useful. I've got to find the previous 10Qs and substract to see what the quarter was. I'd like to see quarterly cash flow statements. **[TI 3/17, p. 37]**

Committee/Staff/Observer
What about the rolling 12 months earnings statement? [Participant I-12] liked that. **[TI 3/17, p. 37]**

Participant I-11
That's more useful in some respect than the interim cumulative because it makes it easier to compare between companies. I follow an industry where there is a number of companies on March and June fiscal years; if I'm trying to compare them with the December fiscal year companies, I have to do a rolling 12 months and I do. **[TI 3/17, p. 37-38]**

Participant I-7
From a valuation point of view, many of us use a rolling 12 months. **[TI 3/17, p. 38]**

Participant I-16
I don't use rolling 12 months for two reasons: first, I follow high-growth stocks where 8 quarters ago is prehistoric; secondly, I much rather look at 9 months versus 9 months than adding the year-end quarter with all the year-end adjustments made in that quarter. **[TI 3/17, p. 38]**

Participant I-12
Seasonality can have a big impact, for retailers for example. The quarter that includes Christmas makes or breaks the company's year. I don't know how a retailing analyst would look at these numbers. **[TI 3/17, p. 38]**

Committee/Staff/Observer
In that example, the 12 months rolling might be more meaningful than the 9 months cumulative that [participant I-16] likes. **[TI 3/17, p. 38]**

Participant I-16
I would argue just the reverse. In that industry, it would be even less meaningful because the most earnings would be in the quarter that is furthest in the past. In the industries that I look at, the highest earnings are generally in the most recent quarter. If I'm looking at the December numbers, do I really care to keep harping on what the comparison was in the December quarter 9 months versus the December quarter 21 months ago? Because that's going to dominate the comparison if you're looking at trailing 12 months. **[TI 3/17, p. 38]**

Committee/Staff/Observer
We hear that analysts want 11 years of information. You're suggesting one quarter? [Also included in 1(b) and 2(c)] **[TI 3/17, p. 38]**

Participant I-16
When I'm looking at how this year is going versus last year, for a retailer, and I'm taking the 12 months through September 30, it's so heavily weighted by the 3 months ended the prior January 1 that I'm really not picking up on what's happened in the last 9 months. My numbers are still being overwhelmed by what happened 9 months ago versus what happened

21 months ago. I want to drop that out, look at the last 9 months versus the 9 months a year before that. **[TI 3/17, p. 39]**

Participant I-12
On the other hand, if you're looking at retailing and you're using a true rolling 12 months, you're always going to have a December quarter in those 12 months. If you're graphing it, I'm a person who likes to use graphs, you can get a lot of information out of the graph of that trend line. **[TI 3/17, p. 39]**

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 2(c)] **[TI 3/17, p. 39]**

Committee/Staff/Observer
Our next question relates to quarterly information for the fourth quarter. Consistent with what we've heard in prior meetings of this group, may we safely conclude that companies should provide financial statements for the fourth quarter of the year? **[TI 3/17, p. 39]**

Participant I-12
Yes. **[TI 3/17, p. 39]**

Participant I-11
Absolutely. **[TI 3/17, p. 39]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of interim reporting.

Committee/Staff/Observer
Looking further then to items C and D, my question is whether the cumulative information currently being received and the cumulative twelve months which some people voluntarily do is desirable? **[TC 3/11, p. 47]**

Participant C-5
I would go with the sliced up pieces. So much depends now on the cyclicality of activity over the last few years. 1992 was a classic example. You couldn't have had a worse first quarter and year-to-date numbers are continually distorted throughout the period. Cycles are moving so much differently now that period slices are more important to me than year-to-date cumulative numbers. **[TC 3/11, p. 47]**

Participant C-15
Are the two mutually exclusive though? **[TC 3/11, p. 47]**

Participant C-5
It's reinforcing the concept that year-to-date is valuable and, in fact, it's not as valuable as quarterly. **[TC 3/11, p. 47]**

Committee/Staff/Observer
How about twelve month ended? **[TC 3/11, p. 47]**

Participant C-5
Twelve month ended is a good point because then it sort of sticks in history. **[TC 3/11, p. 48]**

Participant C-1
Because of seasonality, I use comprehensive quarterly and twelve months and forget about year-to-date. I don't think year-to-date is personally very useful. **[TC 3/11, p. 48]**

Participant C-5
I mentally in my analysis subtract it out. **[TC 3/11, p. 48]**

Participant C-1
We add in other quarters against twelve months. **[TC 3/11, p. 48]**

Committee/Staff/Observer
[Participant C-15] do you feel the same way? **[TC 3/11, p. 48]**

Participant C-15
Yes. **[TC 3/11, p. 48]**

Participant C-10
I agree that twelve months is much more valuable than the year-to-date. **[TC 3/11, p. 48]**

Committee/Staff/Observer
Is that applicable to all companies? All industries? **[TC 3/11, p. 48]**

Participant C-10
I couldn't think of one that it wouldn't. **[TC 3/11, p. 48]**

Participant C-11
I think the most valuable starting point is quarterly. And then you can think about twelve months or something. But, quarterly is where you get your exceptions, your change in trend, your seasonality and so on. [Also included in 11(a)] **[TC 3/11, p. 48]**

Participant C-4
We would choose the integral. We don't really look at rolling twelve month numbers. We set up our credit lines on a twelve month basis based on year end results and then we consistently measure to the year end results. So the integral view is obviously a lot more important to us in that type of analysis. [Also included in 11(d)] **[TC 3/11, p. 50]**

Committee/Staff/Observer
So it's safe for me to say that those of you who use rolling twelve months are not disturbed by current interim use of integral? With the exception that there's no fourth quarter and that's something you do want? [Also included in 11(d)] **[TC 3/11, p. 52]**

Participant C-1
Yes, definitely. [Also included in 11(d)] **[TC 3/11, p. 52]**

Participant C-13
Definitely. [Also included in 11(d)] **[TC 3/11, p. 53]**

Participant C-5
If you're saying that you'd prefer it as an independent as opposed to the closing and the adjusting at year end then I would agree with that. **[TC 3/11, p. 53]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 14

b. Is the optimum interim period for financial reporting (Please choose *ONE.*):

Monthly?	
Quarterly?	*5*
Semiannually?	
Other? Please describe	

If *other than quarterly*, please explain why:
Participant I-11: Personally, I would prefer monthly - but I think the added costs and the risks of misinterpretation exceed the incremental value of monthly reporting.
[PMQI 3/17, p. 26]

[The CIC has commented that] while the annual report remains the primary corporate communication and the quarterly report ranks very high, there is increasing emphasis on "extra efforts" put forth by management. The "factbook" with up to ten-year financial records continues as the most respected extra. Timely and meaningful press releases covering important developments are often cited. Quarterly conference calls and analyst meetings are also becoming more important and may well reflect growing investor concern for short-term "market performance." Many investors cite the absence of a separate fourth quarter report as a continuing sore point. Fax machines are a wonderful tool for the rapid dissemination of hard copy data but this newer means of distribution is often overworked. We stress again that corporate communications should not be confined to the professional investment community but also directed to the general investing public. [Also included in 15 and 16(b)] **[AIMR/CIC92, p. 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), 3(c) 4, 5(a), 5(c), 6, 8(a), 9, 11(c), and 15] **[BETRIOU, p. 1]**

- 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 1(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 1(b), 11(c), and 15] **[BETRIOU, p. 2]**

11(c). Content of Financial Statements and Related Disclosures

Our comments on quarterly reporting herein have two different purposes. First, we wish to make clear and emphatic our unanimous opposition to recent movements by certain individuals and organizations to abolish mandatory quarterly reporting. Our case takes two forms: (a) substantiating the reasons why quarterly reports are vital to analysts and, perforce, for the efficient functioning of the capital markets; (b) showing why the arguments made for the eradication of mandated quarterly reporting are specious.[11] Second, we wish to explicate how quarterly financial reporting needs to and should be improved. [Also included in 11(a)] **[AIMR/FAPC92, p. 35]**

<u>Auditor Involvement</u>

The shorter the period of time covered by financial statements, the lower is the need for auditor involvement. The need for timeliness is inversely related to the length of the reporting period and short-period measurements, which are relatively imprecise, are difficult to verify. With periods as short as three months, there seems to be little value to be added from auditor involvement with the financial reporting process. In fact, such involvement is likely to diminish timeliness, a primary attribute of interim reports. If external auditors are to be involved, their role should be to assist enterprises to establish procedures and routines that minimize the time taken to get reports prepared and lessen the probability of material errors or misstatements. [Also included in 17(d)] **[AIMR/FAPC92, p. 38-39]**

In fact, there may be instances in which the auditor's role in annual reporting could be reduced. In companies with strong financial management, effective financial and managerial controls, supplemented by competent internal auditing, a full annual external audit might not be necessary. In those cases, the external auditor would do more systems testing and evaluation than financial statement verification. What might result would be negative assurance on the financial statements in the format referred to in the professional literature as a "limited review." The review work would largely be composed of assessing the effectiveness of financial and managerial control systems and relying on a high-quality internal audit function. [Also included in 17(d)] **[AIMR/FAPC92, p. 39]**

For enterprises that were to discontinue full annual audits, a time would come when a full external examination of the financial statements would be necessary. This might take place quinquennially. The purpose of that examination would be to provide positive assurance by performing a full audit with emphasis on: (a) complete evaluation of control systems, and (b) a retrospective view of annual income for the five-year period by disclosure of all components of income that make one year not comparable with another. Here is another instance where standards implementing the notion of comprehensive income would be indispensable. We suggest that if and when they are promulgated, the SEC authorize a few selected enterprises to experiment with the changed auditor responsibilities that we suggest. [Also included in 17(d)] **[AIMR/FAPC92, p. 39]**

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[11] The discussion of quarterly reporting in this paper is necessarily limited. For a more comprehensive presentation of analysts' views on the subject, see the following recent publication of AIMR's Financial Accounting Policy Committee: Donald Korn, CFA. *The Need for Quarterly Financial Reports from Publicly Owned Companies: A Response to the Competitiveness Debate*. Association for Management Investment and Research, 200 Park Avenue, 18th Floor, New York, NY 10166, 1992. (Single copies are available without charge upon written request.)

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing their objectives and approach to evaluating equity securities, some investors commented on the content of interim financial statements.

Participant I-11
Our clients, most of them with turnovers far over 15-20% a year, asked us about quarterly results and predictions. Our clients are under short-term performance pressure from their customers, the corporate pension managers. We have to recognize that a long-term trend arises from a series of short-term achievements and the early warning system is a function of the careful attention to quarterly numbers. If I have a complaint about financial reporting today, it is that most companies really shortchange the users community in their interim reports. We don't get nearly the detail, the segment breakdowns, the notes and so on that we get in annual reports. The real world of stock investing today is that a year is an awfully long time (one of my colleagues says that long term is after lunch). Because transaction costs have become so trivial, investors are economically able to capitalize on much smaller changes in market value than they could in the past and they do it. [Also included in 11(e)] **[TI 10/16, p. 12-13]**

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 3(d)] **[TI 10/16, p. 21]**

Participant I-7
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 1(c), 13, and 17(b)] **[TI 10/16, p. 51-52]**

[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, a comment was made on the content of interim financial statements.

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 3(e)] **[TI 12/9, p. 18]**

[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 balance sheet display, a comment was made on the content of interim reports.

Committee/Staff/Observer
How disruptive would it be if you didn't have a balance sheet? [Also included in 5(b) and 5(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 5(c)] **[TI 1/13, p. 36]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting.

Committee/Staff/Observer
Other questions on interim reporting. May we safely conclude that you prefer quarterly reporting as opposed to monthly or semi-annually? Also, may we conclude that you prefer full interim financial statements as opposed to just disclosure of summarized interim data? [Also included in 11(a)] **[TI 3/17, p. 36]**

Participant I-11
I'd say yes to both. [Participant I-12] touched on a key element. The greatest opportunities for inappropriate valuations to occur in stocks is when there's a change of direction in the

company's business. We all spend a lot of our time trying to identify times when a company's business is changing direction. It's a balancing act because there's a lot of static in the data. It seems to me that the quarterly financial report is a pretty good filter for that. If you get much shorter than a quarter, there's too much static. If you get much longer than a quarter, it's too late. Also, we all want full financial statements instead of summary information. [Also included in 11(a)] **[TI 3/17, p. 36-37]**

Committee/Staff/Observer
The next question relates to the level of detail provided in interim financial statements. Should companies be required to provide more detail than is now typical of the condensed quarterly financial statements that are currently provided? If so, should interim statements provide the same level of detail as annual financial statements? **[TI 3/17, p. 40]**

Participant I-12
I would like as much detail as I can get my hands on. But I don't know that it has to be as complex as the annual report, although my experience with larger companies has been that they have the ability to produce that information at that level of detail and it would be extremely useful to me to see that information. I would wonder whether the cost-benefit ratio would be overwhelming for smaller companies. But for the most part, for the companies that I cover, I'd like to get the same level of detail as annual statements if I could. **[TI 3/17, p. 40]**

Participant I-11
I hope management is looking at more detailed statements than those provided quarterly. **[TI 3/17, p. 40]**

Committee/Staff/Observer
When talking about quarterly statements, we spend 95% of the time focusing on the results of operations, and a little bit on cash flows. Is there a lot of interest in quarterly information that relates to financial position? **[TI 3/17, p. 40]**

Participant I-11
Sure. **[TI 3/17, p. 40]**

Participant I-12
You bet. **[TI 3/17, p. 41]**

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 2(a)] **[TI 3/17, p. 41]**

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 3(d)] **[TI 3/17, p. 41]**

Committee/Staff/Observer
Does the market already penalize those companies? [Also included in 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[TI 3/17, p. 42]**

Participant I-12
Yes, they wouldn't provide it otherwise. [Also included in 3(d)] **[TI 3/17, p. 42]**

Participant I-7
In my industry, the strongest companies don't provide that information. [Also included in 3(d)] **[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 3(d)] **[TI 3/17, p. 42]**

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 5(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 5(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 5(c) and 11(d)] **[TI 3/17, p. 47]**

Committee/Staff/Observer
There was some sympathy for full quarterly statements. Given the highly-charged litigation environment, and talking about a multinational company that has to collect all the data around the world and put it together within 45 days, are you suggesting that you really need that and that it should be a requirement for all public companies? Or would you make exceptions when it's not practical or costly? **[TI 3/17, p. 47]**

Participant I-16
How do you know what your total current liabilities are if you don't know what the components are? **[TI 3/17, p. 47]**

Committee/Staff/Observer
You can make approximations of these numbers without all the precise details. **[TI 3/17, p. 47]**

Participant I-16
I think you need to know the components. So why can't you give me the components? If you have a total, you have to have at least an estimate of the components. **[TI 3/17, p. 48]**

Committee/Staff/Observer
You presume it's there then and we might just as well give it? **[TI 3/17, p. 48]**

Participant I-16
It's there. **[TI 3/17, p. 48]**

[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 interim reporting.

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]'s question would be that I think that at this point establishing core earning power is maybe more critical. [Also included in 3(d) 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 3(d)] **[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 3(d)] **[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 3(d)] **[TC 12/8, p. 38]**

Participant C-13
Same as annual. [Also included in 3(c) and 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[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 3(d)] **[TC 12/8, p. 39]**

Participant C-11
I was just going to strongly reinforce what [participant C-15] 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 3(d)] **[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 3(d)] **[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 3(d)] **[TC 12/8, p. 40]**

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 1(b), 13, and 17(a)] **[TC 12/8, p. 52-53]**

[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.
[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 interim reporting.

Committee/Staff/Observer
Question 11 deals with interim reporting. We presume that currently people prefer quarterly reporting as opposed to a move to more frequent reporting such as monthly. And we also presume that they prefer summarized information than the more detailed information, such as in the annual report. Those are items A and B on page 13 of the meeting materials. If someone has a belief that we have gotten that wrong from previous discussions, this would be a great time to register your complaint. [Also included in 11(a)] **[TC 3/11, p. 46]**

Participant C-11
I disagree. In many companies I have the same kind of data quarterly than is put in the annual report. And I'm talking about all the stuff in the net interest margin table, all the important detail of loan quality in terms of types of nonperforming loans and all that. The summary of annual data in the quarterly reports can be carried to a point where you're ending up giving no

information. A lot of companies still don't give good cash flow information in their quarterlies. There are just many areas that the basic information that you use and need you want quarterly as well as annually. **[TC 3/11, p. 46]**

Participant C-5
Cash flow is irrelevant at a bank. **[TC 3/11, p. 46]**

Committee/Staff/Observer
I have misstated B so let me read it out loud so we don't labor under that delusion. May the special committee safely conclude that most investors, creditors and analysts prefer interim financial statements to disclosure of summarized interim financial information . . . ? **[TC 3/11, p. 46-47]**

[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 interim 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 3(d), 15, and 19] **[TC 3/11, p. 69]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 14

c. Regarding interim reporting, please indicate your *agreement or disagreement* with the following:

	Agree	*Disagree*
1. Quarterly reporting is more valuable than year-to-date reporting because quarterly reporting highlights recent changes in business activities.	*4*	*1*
2. Moving twelve month information is more useful than year-to-date reporting.	*2*	*3*

	Agree	*Disagree*
3. Current interim reporting for public companies should <u>require</u> moving twelve month information. *Participant I-11*: Neutral	*1*	*2*
4. Current interim reporting for public companies should <u>require</u> separate reporting of fourth quarter activities. *Participant I-9*: Interesting idea.	*4*	*1*
5. Interim reporting for public companies should be expanded from its current condensed format to a more detailed presentation *but less than* full statements identical to annual detail. *Participant I-9:* It should be as close to full year reporting as can be reasonably done on a timely basis.	*3*	*2*
6. Interim reporting for public companies should be expanded from its current condensed format to a more detailed presentation *with as much detail* as is given in annual financial statements.	*3*	*2*

[PMQI 3/17, p. 26-27]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 15

c. Regarding interim reporting, please indicate your *agreement or disagreement* with the following:

Participant C-11: These are not either/or situations.

Agree **Disagree**

_8_ _4_ 1. Quarterly reporting is more valuable than year-to-date reporting because quarterly reporting highlights recent changes in business activities.

Participant C-8: Answer depends upon industry. YTD information is very valuable for small construction contractors.

_4_ _8_ 2. Moving twelve month information is more useful than year-to-date reporting.

Participant C-8: Same as above.

Participant C-21: Depends on industry and operating style.

_5_ _6_ 3. Current interim reporting for public companies should <u>require</u> moving twelve month information.

Participant C-14: Can do it ourselves, though.

Participant C-21: In addition to quarterly information (?)

_13_ __ 4. Current interim reporting for public companies should <u>require</u> separate reporting of fourth quarter activities.

Participant C-14: 10Q's are ideal.

_10_ _1_ 5. Interim reporting for public companies should be expanded from its current condensed format to a more detailed presentation *but less than* full statements identical to annual detail.

Participant C-11: Depends on what detail.

__ _12_ 6. Interim reporting for public companies should be expanded from its current condensed format to a more detailed presentation *with as much detail* as is given in annual financial statements.

Participant C-11: Some detail in the annual is not needed.

_7_ _4_ 7. Interim reporting accounting rules should emphasize the "integral" approach that determines accruals, deferrals, and estimates by allocating them throughout the year rather than discretely reporting them as they occur.

Participant C-11: Depends on item. Many items such as sales should be discrete.
[PMQC 3/11, p. 23-25]

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

With the exception of disclosure of management's forecasts and projections, the analysts generally confirmed that [the following] list of areas for improvement is both accurate and complete. In particular, most emphasized the importance of disaggregated information. In contrast, most of the analysts were uncertain about management's forecasts and projections.

Many were concerned about whether they could ever rely on those forecasts. [Some believe] that analysts [themselves] should develop their own forecasts. [The list recommends:]

1. better disaggregated information.
2. more complete quarterly reporting. That is, interim reporting that more closely resembles annual reporting.
3. better identification and explanation of extraordinary, unusual, and infrequent items.
4. better information about measurement uncertainties, and operating opportunities and risks.
5. improved comparability and consistency in financial reporting methods over two business cycles, including disclosure of ten year summary information.
6. disclosure of the company's goals and objectives
7. better clarity in external reporting without reducing the amount of information.
8. disclosure of management's forecasts and projections.

[Also included in 12 and 15] **[GOLDMAN, p. ii-iii]**

Every analyst emphasized the critical role in their work of external financial reporting. They also affirmed the importance of audited financial statements.
[Also included in 12 and 15] **[GOLDMAN, p. iii]**

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), 5(c), 6, 8(a), 9, 11(b), and 15] **[BETRIOU, p. 1]**

- 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 1(b), 11(b), 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 1(b), 11(b), and 15] **[BETRIOU, p. 2]**

11(d). Integral and Discrete Approach

<u>Integral Versus Discrete Approach to Interim Reporting</u>
In 1973, the Accounting Principles Board, in Opinion No. 28, mandated the integral approach to reporting quarterly earnings. Under that opinion the accounting period is defined as being one year and quarterly periods are to be regarded as "integral" segments of the annual period. The effect of that standard is to allow the allocation of period costs across interim periods on the basis of benefits received, time elapsed, or other even more arbitrary bases. The result has been allocation that in actuality has ranged from smoothing into outright manipulation of quarterly earnings. Expenses, such as advertising, research, maintenance, income taxes, and so on, are reported discretely year by year. Yet, on a quarterly basis, they are unabashedly smoothed and often in ways that appear dubious. **[AIMR/FAPC92, p. 38]**

In its early years, the FASB placed on its agenda a reconsideration of APBO 28. AIMR's Financial Accounting Policy Committee submitted comments strongly supporting the discrete method. But the project was removed from the FASB's agenda and APBO 28 continues to prevail. We believe that financial analysis is best served by financial reporting that reports transactions as and when they occur. If there is smoothing to be done, it is the province of analysts to do it. If there are financial reporting anomalies that are attributable to seasonality, it is far better to report and explain them than to conceal them with undocumented smoothing. Thus, we recommend changing interim reporting from the integral to the discrete method. **[AIMR/FAPC92, p. 38]**

[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 referred to the integral versus discrete approach to interim reporting.

Committee/Staff/Observer
Should there be any auditor involvement with quarterly reports or once a year is enough? [Also included in 17(b) and 17(d)] **[TI 3/17, p. 12]**

Participant I-16
I think the quarterly issue has to be deferred towards the later discussion of what you want quarterly reports to be, in terms of whether they should be like annual reports, that is, discrete periods, or whether they should be an integral part of the whole year (thus, with some smoothing). You need to decide that before deciding whether they should be audited or not. [Also included in 17(b) and 17(d)] **[TI 3/17, 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.

Committee/Staff/Observer
Question 11, also on interim reporting, describes two views: the discrete view and the integral view. Accounting standards have adopted the integral view. Our question is: are you satisfied with interim reporting based on the integral view? If not, do you agree with its critics that accruals and estimates at the end of an interim period should be determined by the principles that apply to annual periods, and transactions should be reported in the interim periods in which they occur, and any smoothing to be done should be left to analysts? **[TI 3/17, p. 42]**

Participant I-16
I have some sympathy for the discrete view. It makes things more explicit; management would have to explain why something may look strange or unusually volatile. Under the integral system, you can cover up things for a long time using estimates. I would want to give a lot of thought to moving to the discrete view. If a company does something that makes sense and that's going to make the short-term numbers look worse, it will force the company to explain that to analysts rather than pretending that it didn't happen. **[TI 3/17, p. 42-43]**

Participant I-12
Most of us operate on the discrete view but I think there is an argument for the integral view. For example, in retailing you have seasonal factors, and in the financial services industry there is the issue of bonus compensation; you may get one terrific quarter where the bonus compensation that will be paid at the end of the year is going to be substantially higher than the company originally thought. So they'll raise each of the following quarters' estimates of bonuses; that tends to smooth a bulge. While we look at discrete periods, I think there's also an element of the integral view that makes some sense. **[TI 3/17, p. 43]**

Participant I-7
It depends on the industry. What happens if you're a military supplier and you're building a submarine that takes 3 years to deliver using the percentage of completion method. Or worse, if you are a supplier in the nuclear industry that may take 7 or 8 years to provide hardware for a site. In those cases, I have a problem taking one or the other view. **[TI 3/17, p. 43]**

Committee/Staff/Observer
In your example, I don't think the discrete method would negate the use of the percentage of completion method for that contract. **[TI 3/17, p. 43]**

Participant I-5
To some extent, when you have specific events causing longer term accruals, you end up treating years as part of an integral longer period. Quarters should obviously then also be part of a longer period. **[TI 3/17, p. 44]**

Committee/Staff/Observer
But we clearly have discrete years. You don't make an assumption at the end of the year that it is part of an integral era. The question is: do you cut it like that for a quarter? **[TI 3/17, p. 44]**

Participant I-5
What would be one instance of when you make an estimate for a quarter that you wouldn't make for a year? **[TI 3/17, p. 44]**

Committee/Staff/Observer
Advertising expenses, for example, where a company concentrates advertising in the second quarter and they argue that it benefits the whole year, so they spread the advertising costs ratably over 4 quarters. **[TI 3/17, p. 44]**

Participant I-16
I would like to know that a company is engaged in a major step-up in its advertising in the second quarter and not just find out that they're going to be up 5% for the year. If they're going to be up 50% in the second quarter, most likely it's some kind of new program and I'd like to ask them questions about it. Again, with the discrete viewpoint, you force more disclosures to be made. **[TI 3/17, p. 44]**

Committee/Staff/Observer
So you would expense it, but disclose it. **[TI 3/17, p. 44]**

Participant I-16
Yes, management will disclose things that is in management's interest to disclose. If something is disadvantageous by using the discrete method, they will disclose information about it. If you use the integral method and spread it out, there is no reason to disclose information about it. I would like to maximize the chance that it will be disclosed and be a subject of discussion. **[TI 3/17, p. 44-45]**

Committee/Staff/Observer
But if you could be sure that it would be disclosed, it wouldn't make any difference what the numbers were? **[TI 3/17, p. 45]**

Participant I-16
Yes. **[TI 3/17, p. 45]**

Committee/Staff/Observer
Let me give you another example: a major repair that happens in the second quarter and was not budgeted. Management says that it's clearly repair, not a capital expense. Management decides to spread the effect out over the next two quarters. That's a better example of the difference between the discrete and integral approaches. Should that repair be recognized as an expense fully in the second quarter or should it be spread to the second, third, and fourth quarter? **[TI 3/17, p. 45]**

Participant I-5
If the benefit you received from having made that repair is longer than for one year, then the repair should be capitalized. **[TI 3/17, p. 45]**

Participant I-16
The repair just restored you where you were; it doesn't increase value. **[TI 3/17, p. 45]**

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 5(c) and 11(c)] **[TI 3/17, p. 45]**

Participant I-16
The problem here is that we're ignoring one thing; we're assuming that everything else remains the same other than the accounting. If you change the accounting, you change people's behavior. If you can't spread the cost of that repair, you buy insurance to spread the cost. This thing would be the greatest thing for the insurance industry. The reason why I said that in theory I like the discrete approach but that I'm not sure, is because that management may react to it in a way that I'm not sure I want them to. There might be other things that might have real costs; the example of buying insurance to protect against things for which they really should not pay insurance premiums for, might be an unintended cost that the shareholders would have to bear. Another example: it might make a lot of sense to do that TV advertising in the second quarter; spot TV advertising time may have come down but the company may decide not to do that because they can't spread the cost over the full year. So they might pay more to buy spot advertising time in the third quarter. That's the kind of things I worry about; there may be some real consequences here as companies try to evade the consequences to a change to the discrete methodology. **[TI 3/17, p. 46]**

Committee/Staff/Observer
Having said all that, you're now on the FASB and you have one vote; discrete or integral? **[TI 3/17, p. 46]**

Participant I-16
I would want to hear the other side of the argument from somebody from the company; does it really create a problem for them? To me, it's a slight benefit to go to the discrete method, but it's not something I would insist on. **[TI 3/17, p. 46]**

Participant I-11
I lean toward the integral method. I'm also concerned about unanticipated consequences. I think about what happened in the wake of the postretirement benefits standard, where there have been some tremendous unanticipated consequences in terms of companies solving the problem by doing away with postretirement benefits. I don't think the FASB intended or anticipated that, but in reality it happened. The discrete method theoretically sounds better; I'm afraid though that none of us have thought through closely enough what it would mean. **[TI 3/17, p. 46-47]**

Participant I-12
Like [participant I-11], I would tend to lean toward the integral approach if I could get quarterly cash flow statements. [Also included in 5(c) and 11(c)] **[TI 3/17, p. 47]**

Committee/Staff/Observer
Assuming you couldn't? **[TI 3/17, p. 47]**

Participant I-12
There is a big issue with the unintended consequences and it concerns me. **[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 5(c) and 11(c)] **[TI 3/17, p. 47]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of interim reporting.

Committee/Staff/Observer
Question 12 can be characterized as integral versus discrete and basically ask the question that we dealt with in smoothing perhaps on a micro scale and says in effect you have a choice when you're doing interim financial statements to anticipate what the year as a whole is going to look like and set accounting accruals and conventions in anticipation of the year or you can account for things pretty much as they happen without anticipating reversals of losses and other kinds of things that balance out a year. Some people have characterized much of accounting currently under an integral notion, although I'm not sure that that's altogether applicable. The question we ask you is whether or not integral versus discrete, that is, smoothing across a year versus having everything essentially accounted for as it occurs makes a difference to you and, if so, which one do you choose? **[TC 3/11, p. 50]**

Participant C-4
We would choose the integral. We don't really look at rolling twelve month numbers. We set up our credit lines on a twelve month basis based on year end results and then we consistently measure to the year end results. So the integral view is obviously a lot more important to us in that type of analysis. [Also included in 11(b)] **[TC 3/11, p. 50]**

Participant C-11
I certainly want to know about the seasonality or cyclicality of important revenue and expense items but I am aware of certain things where the particular cost is based on an annual performance or estimate and you cannot necessarily know anything different from quarter to quarter unless the business really changes materially. And the ones that I've thought about over the years in that context are things like management bonus awards, which are based on an annual payment. Also the complex tax area where for many companies it's complicated enough to figure out taxes and having a rough estimate of understanding for the year and if that had to be thought about quarterly, it would produce a lot of stress. So my answer is there may be areas where it is not worthwhile to readjust everything quarter to quarter based on that quarter's earnings and results. **[TC 3/11, p. 51]**

Committee/Staff/Observer
With respect to the approach that is currently being used which does emphasize integral, does that cause a problem for you now? **[TC 3/11, p. 51]**

Participant C-11
In my mind, you're going back to the smoothing question and I think there are limits to what you should smooth. **[TC 3/11, p. 51]**

Committee/Staff/Observer
But in terms of interim reporting of management bonuses, taxes, things like that, the way we're doing it now, do I hear you telling me it is acceptable from an analyst's point of view? **[TC 3/11, p. 51]**

Participant C-11
Yes. **[TC 3/11, p. 51]**

Participant C-7
We'd probably adopt an integral view at the expense level but maybe focus more discretely on the revenue side. **[TC 3/11, p. 51]**

Participant C-6
In my experience, the interim information that we receive when we receive it is really a truer picture of what's happening with the company than the year end statement. Because obviously many privately-held companies do year end tax plan and obviously they suppress profits. Whereby during the interim periods that's not done and you will see a truer picture of what the company is actually doing. So when we do get interim statements, and we try very hard to get them, I think it gives more of a real instinctive look at what's going on. **[TC 3/11, p. 52]**

Participant C-13
I would think those who like rolling twelve months wouldn't like the integral method because it severely distorts your twelve month rolling. I prefer to look at slicing the borders as [participant C-5] put it. So the integral doesn't bother me particularly. But if you rely a lot on twelve month rolling, the integral is going to throw you off. **[TC 3/11, p. 52]**

Participant C-10
Reading the two descriptions you give here, I would go for the discrete. I'd rather have things stand alone more on their own. **[TC 3/11, p. 52]**

Participant C-1
I think [participant C-7]'s view is really right on, discrete in terms of revenue and expenses related specifically to that revenue, more integral with relationship to longer term expenses. **[TC 3/11, p. 52]**

Committee/Staff/Observer
So it's safe for me to say that those of you who use rolling twelve months are not disturbed by current interim use of integral? With the exception that there's no fourth quarter and that's something you do want? [Also included in 11(b)] **[TC 3/11, p. 52]**

Participant C-1
Yes, definitely. [Also included in 11(b)] **[TC 3/11, p. 52]**

Participant C-13
Definitely. [Also included in 11(b)] **[TC 3/11, p. 53]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 15

Interim financial statements are less reliable than annual financial statements, and the numbers tend to fluctuate more, because they depend more on estimates, allocations, and judgments than annual statements. In general, the shorter the period on which statements report, the greater the volatility and the greater the questions that are raised about their reliability.

Accounting standards have attempted to reduce the effects of short periods on interim reporting by making each period an integral part of the annual period, and deferrals, accruals, and estimates at the end of each interim period are affected by judgments made at the interim date about earnings for the annual period. As a result, an expense that falls wholly within an annual period (no accrual or deferral at year-end) may be allocated to interim periods based on estimated time, sales volume, productive activity, or some other basis. Supporters of that integral view argue that it allows companies the necessary latitude to best reflect the earnings during the interim period and to reduce unnecessary and unhelpful volatility.

However, some investors and creditors, and some accountants, argue that the integral view in accounting standards is a source of serious problems with interim financial statements because it results in allocations that have ranged from smoothing to outright manipulation of quarterly earnings that undermines analysts' ability to detect real changes on a timely basis. They argue that financial analysis is best served by financial statements that report transactions as and when they occur and recommend a switch from the integral view to the discrete view, in which earnings for each interim period is determined in the same way as earnings for an annual accounting period--deferrals, accruals, and estimates at the end of an interim period are determined by the same principles and judgments that apply to annual periods. They ask that economic anomalies that are attributable to seasonality be disclosed and discussed rather than concealed by undocumented smoothing.

Are you satisfied with interim reporting based on the integral view?

YES *2*
NO*3*

Participant I-9: In some industries, toys for instance.

Or do you agree with its critics that:

• Accruals, deferrals, and estimates at the end of an interim period should be determined by the principles that apply to annual periods, and revenues and expenses should not be allocated between interim periods if they would not properly be allocated between annual periods?

YES *3*
NO*2*

• Transactions should be reported in the interim periods in which they occur, and any smoothing to be done should be left to analysts?

YES *3*
NO*2*

Comments
Participant I-16: I favor discrete reporting, but have some concerns that managements unable to smooth earnings trends by allocations will alter the timing of transactions for reporting, rather than economic reasons.
Participant I-11: I'm not comfortable with my answers here. I've dealt with companies where the integral view creates problems and I'd like a way of coping with those problems. I'm not sure, though, that the discrete view would do more than swap one set of problems for another. At the very least it would probably would lead to an unsettling transition period for analysts.
Participant I-7: Yes, if all assorted information to handle this is issued.
[PMQI 3/17, p. 27-28]

11(e). Other

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 1(b)] **[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 1(b)] **[SRI, p. 57]**

Analysts tend to employ annualized data but we infer 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 1(c)] **[PREVITS, p. 12-13]**

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), 3(b), and 11(e)] **[PREVITS, p. 15]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on investors' objectives and approaches, comments were made on the emphasis on short-term earnings.

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 1(a)] **[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 1(a)] **[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 1(a)] **[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 1(a)] **[TI 10/16, p. 12]**

Participant I-7

Some of my very large companies have changed their pension fund managers twice a year based on bad quarterly numbers. If you're following a mature industry, your view can be longer term in nature. For hightech companies, the higher the tech, the more critical the current evaluation period as far as earnings are concerned. For relatively mature industries, what happens over one or two quarters doesn't necessarily negate your view from an annual point of view. But when you're looking at fast pace industries, the integrated circuit industry for example where every 3 to 6 months your life cycles can change, you better see what's going on on a 3 month basis because it becomes highly predictive. **[TI 10/16, p. 12]**

Participant I-11

Our clients, most of them with turnovers far over 15-20% a year, asked us about quarterly results and predictions. Our clients are under short-term performance pressure from their customers, the corporate pension managers. We have to recognize that a long-term trend arises from a series of short-term achievements and the early warning system is a function of the careful attention to quarterly numbers. If I have a complaint about financial reporting today, it is that most companies really shortchange the users community in their interim reports. We don't get nearly the detail, the segment breakdowns, the notes and so on that we get in annual reports. The real world of stock investing today is that a year is an awfully long time (one of my colleagues says that long term is after lunch). Because transaction costs have become so trivial, investors are economically able to capitalize on much smaller changes in market value than they could in the past and they do it. [Also included in 11(c)] **[TI 10/16, p. 12-13]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion on investors' objectives and approaches, comments were made on interim reporting.

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 2 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 2(d)] **[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 1(c) and 3(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 1(c)] **[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 1(c)] **[TI 10/16, p. 55]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of interim reporting.

Committee/Staff/Observer
Question 10 deals with interim reporting (page 13 of the materials). Our first question is: why do you use interim financial reports? Question 10(a) of the meeting materials gives 3 possible answers and I'm sure there are many more. **[TI 3/17, p. 35]**

Participant I-16
Two reasons; first, because they're there and you can't ignore anything that is there. Secondly, they are sort of measuring standards. In constructing your view of a company and

its valuation, you have a certain view of where it's going and you want to know if it hits the mile post when it is supposed to. If you think that a company can get to a certain earnings level at a certain point in time, the interim numbers tell you whether they are on track, above or below track. It then tells you how reasonable your long-term expectations are. You're not going to value a company based on what you think they are going to earn in the next quarter; it's a longer term process. But you have to decide whether you are going to modify your long-term view of the company's prospects based upon an interim report. So it's a mile post on a long journey. **[TI 3/17, p. 35-36]**

Participant I-7
Primarily as an early warning or indicator of which way the company is going and how fast it's proceding in that direction. Essentially what [participant I-16] said. **[TI 3/17, p. 36]**

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 1(c)] **[TI 3/17, p. 36]**

[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, a comment was made on interim reporting.

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 1(b)] **[TC 12/8, p. 51]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 14

a. Do you use interim financial reports in your analysis (please choose *all* that apply):

11(e). Other--Page 5

For essentially the same purpose(s) and in essentially the same way(s) as you use annual financial reports?	*4*
Primarily to predict earnings or cash flows for the year of which the interim period is a part?	*4*
Primarily as an early warning indicator that tells you in which way a company is going and roughly how fast it is proceeding in that direction?	*5*
Something else. Please describe:	*Participant I-11:* To predict earnings or cash flows for the year subsequent to the year in question.

[PMQI 3/17, p. 26]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 15

a. Do you use interim financial reports in your analysis (please choose *all* that apply):

_8_ For essentially the same purpose(s) and in essentially the same way(s) as you use annual financial reports?

Participant C-4: With less detail in our analysis, identify trends, cap ex,. uses of funds, etc.

_7_ Primarily to predict earnings or cash flows for the year of which the interim period is a part?

Participant C-11: Not primarily.

Participant C-21: Not always able to predict. Depends how sophisticated company's financial information is.

_11_ Primarily as an early warning indicator that tells you in which way a company is going and roughly how fast it is proceeding in that direction?

Participant C-14: Most here.

_0_ Something Else.
Please Describe:

11(e). Other–Page 6

Participant C-17: As a comparative tool to the prior comparable period to determine two items above checked.
[PMQC 3/11, p. 22-23]

12. Forward Looking 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	□

12. Forward Looking 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]**

- Projections and forecasts are helpful financial information; however, projections and forecasts need not be part of the basic financial statements. **[FASOversight, p. 2]**

Need for a One-Year Cash Flow Statement [following 3 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 5(c)] **[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 5(c)] **[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 5(c)] **[RMA92, p. 4]**

> 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 (a) and 3(e)] **[HILL KNOWLTON, p. 10]**
>
> - "I'd like the annual report to show sales and earnings projections over the next ten years for each business segment." (Milwaukee brokerage analyst) **[HILL KNOWLTON, p. 10]**

> "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 1(b)] **[SRI, p. 32]**

[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, 5(a), 8(c), 11(a), 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), 4, 5(a), 8(c), 11(a), 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.

> 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 1(d)] **[AIMR/FAPC92, p. 61]**

[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 a specific question on the use of forward looking information.

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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[TI 10/16, p. 48]**

Participant I-10
I think it's crazy. [Also included in 1(b)] **[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 1(b)] **[TI 10/16, p. 49]**

Committee/Staff/Observer
We're certainly not talking about requiring a five 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 1(b)] **[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 1(b)] **[TI 10/16, 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, comments were made on forward looking information.

Committee/Staff/Observer
. . . [W]ould you find projections of future performance prepared by management and audited to be of value? [Also included in 17(c)] **[TI 3/17, p. 17]**

Participant I-12
No. [Also included in 17(c)] **[TI 3/17, p. 17]**

Participant I-16
Yes. I don't see why that has to be audited, but I think that is something that management should be encouraged to do. If I own 100% of a business and I had somebody running it, I would ask to see his plans for the coming year. I understand that for a company with 1 million shareholders, you're not going to put out that kind of detail. But giving some indication of what you anticipate being able to accomplish in the future, the obstacles that you have to overcome, and the opportunities that you pursue, I think management should be encouraged to provide broad guidelines on that. And I don't think they should be encumbered by the auditors in that regard. I think that's between management and shareholders and I don't think the auditor has a role in that. If the auditor did have a role, it would dampen the explicitiveness of what management is saying; you don't want boilerplate, you want something that is meaningful. [Also partly included in 10(c) and included in 17(c)] **[TI 3/17, p. 17]**

Participant I-7
Coming back to [committee/staff/observer] comment about companies in the same major industry having different auditors, it puts auditors at a great disadvantage when asked to express an opinion about management's forecasts compared to analysts following a specific industry and being able to look at the whole forest. Auditors don't have the sense of what's going on from a competitive point of view. I see no reason for the auditors to be involved with management's forecasts. [Also included in 17(b) and 17(c)] **[TI 3/17, p. 18]**

Committee/Staff/Observer
I'd like to challenge that. Management makes a projection which is based upon estimates and assumptions. You said you want us to be involved in historical financial statements, in either expanding in a note or in an AD&A, by having standards to disclose more about measurement uncertainties. Those same uncertainties enter into a projection. As a starting point, couldn't the auditor be properly involved in a projection by expressing an opinion about whether management's assumptions are realistic (based on x dollars, x volume, x units)? [Also included in 9 and 17(c)] **[TI 3/17, p. 18]**

Participant I-12
That's our business, that's what we do. There's no need for us if the auditor is going to do it. [Also included in 9 and 17(c)] **[TI 3/17, p. 18]**

For real estate properties, there are current appraisals on most of these properties. Theoretically, banks and other financial institutions have set aside reserves to appropriately reduce the value of the assets to reflect the current situation. I don't know if real estate prices are going to go up or down; I will look at all of that and I'll make an estimate of my own. What I would like the accounting profession to do is to make it clear to me what the basis of all of that is. A question analysts ask a lot is: what percentage of original value have your nonperforming real estate loans be written down? If we know how much has already been written down, we then have some information that will help us make estimates about how much more write-downs should be made given our general outlook. I would like to know what has already been done and what the status is. Managements are always making estimates; analysts try to know what the assumptions are and make their own estimates that can be radically different. I'm not sure the accounting profession needs to get involved in future estimates; the most important function of financial statements is clarity. [Also included in 9, 17(b), and 17(c)] **[TI 3/17, p. 19]**

Participant I-11
The MD&A should be a discussion by management of the operating events that produce the financial statements. We all know that's not what it usually is. It's usually a regurgitation of the numbers. Similarly, the AD&A would be the auditors' discussion of the way the accounting principles and techniques were applied to the operating events to produce the financial statements. In that context, I think it's appropriate to have the auditors involved in estimates. For example, taking the real estate portfolio example, the balance sheet shows that on the balance sheet date there was an asset called real estate portfolio, and the value assigned to that asset was reached by making certain assumptions or estimates. In order to judge the accuracy of that figure, a user needs to have an idea of what those estimates were. As far as estimates in the future are concerned, I think [participant I-12] is right; that is what we're doing and I don't get any additional comfort by having an auditor tell me that management's estimates are good or bad because I'm making my own anyhow. A few years ago, when [name deleted] tried to do a big deal based on some projections of air travel that had factors and yields going nothing but up, that deal never got done because independent financial analysts said the assumptions were preposterous. [Also included in 13, 17(b), and 17(c)] **[TI 3/17, p. 21]**

Participant I-16
Perhaps there is a problem here with two different types of transactions. For manufacturing companies, we're dealing with transactions that occur in the future. Companies are going to provide a service and be paid for it. While in many financial business, transactions occurred 5 years ago and what we're putting in the financial statements are the results of those past transactions. For example, insurance companies selling a policy where you're not going to find out for 5 years whether the person dies or not, or gets sick, or his house collapses. Or lend money to a hotel and you don't know whether the hotel is going to be able to service the debt. Maybe there are different types of transactions here, but most of the transactions we deal with outside of financial transactions are prospective transactions. A forecast does not relate to questions of what happened in the past. A forecast of how many of [name deleted] is going to sell next year, I don't think that the auditors' job, that's my job as a software

analyst. But if I were doing a bank, I would have to know what is the status of the loans I made 5 years ago because that has a bigger impact on my reported earnings of 1993 than the loans I make in 1993. [Also included in 17(b) and 17(c)] **[TI 3/17, p. 21-22]**

Participant I-16
I would not grant that an auditor could write a good MD&A. If an auditor could, he's not doing his auditing job; he's spending too much time learning the nuances of the business. Management can write a much better MD&A than the auditor. Secondly, if the auditor is going to get involved in making projections or auditing projections about the future, the auditor is no longer independent. He now has a vested interest in the future financial reports corresponding to those forecasts; his objectivity is lost and I can no longer rely on his opinion. [Also included in 17(c)] **[TI 3/17, p. 23]**

[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 forecasts and projections.

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 1(b)] **[TC 12/8, p. 25]**

Participant C-5
The items that we are always looking for are projections on 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 1(b) 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 1(b) 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 1(b) and 13] **[TC 12/8, p. 51]**

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 1(c)] **[TC 12/8, p. 62-63]**

Participant C-14
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 1(c)] **[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 1(c)] **[TC 12/8, p. 63-64]**

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 1(c)] **[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 1(c)] **[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 1(c)] **[TC 12/8, p. 66]**

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 1(c)] **[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 1(c) 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 1(c)] **[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 1(c) 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 1(c)] **[TC 12/8, p. 70]**

Participant C-12
It 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 is 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 1(c) 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), 1(c), 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 1(c)] **[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(c), 1(d), 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 1(c)] **[TC 12/8, p. 72]**

Committee/Staff/Observer
When you get those projections, then, what do you do? [Also included in 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[TC 12/8, p. 74]**

Committee/Staff/Observer
Now, let me go back to [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 1(c)] **[TC 12/8, p. 74]**

Participant C-16
By agreement, yes. [Also included in 1(c)] **[TC 12/8, p. 74]**

Participant C-7
Same situation. It's negotiable. [Also included in 1(c)] **[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 1(c)] **[TC 12/8, p. 74]**

Participant C-4
I can't remember the last time I've seen a going concern opinion on a financial statement. I don't know how much forward looking work auditors are doing when they're doing their audit work, and then how much historic hindsight review they're doing when they're auditing of financial statements. It's not happening, particularly as I mentioned earlier, in the percentage of completion accounting. [Also included in 17(b) and 17(c)] **[TC 12/8, p. 74]**

Participant C-15
I think that in certain industries, the utility industry, for example, it is common for companies to give a projection of what their three year or five year construction program is. So maybe some base level of information going forward could be provided in the financial statements, as opposed to full P&L and balance sheet for five years. **[TC 12/8, p. 74]**

Participant C-3
A lot of companies at least put in next year's expected capex. **[TC 12/8, p. 75]**

Committee/Staff/Observer
I think there is a distinction, though, there between what might be committed versus what might be planned. The public reporting is more along the commitments line as opposed to a plan might be for the next three years. **[TC 12/8, p. 75]**

Participant C-15
Well, even for utilities, there was--if I remember right, there was flexibility in the fact as to when they would time different expenditures, particularly when you're not talking about the big generating plant, but some of the transmission lines, or whatever. **[TC 12/8, p. 75]**

[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 meeting, comments were made on forward looking information.

Participant C-17
The way I look at this is that I want help from you folks in terms of being able to identify a quantifiable risk, something that's measurable. Insurance that you dropped. But I don't want an accountant getting involved in trying to determine the future. I think that's management's responsibility, and my responsibility. [Also included in 10(b)] **[TC 2/2, p. 31]**

Participant C-13
I agree with that. I approach this whole thing with a fair degree of skepticism. I agree with what [participant C-11] said, I draw the analogy with the discussions of forecasting. I don't think that forecasting has a place in financial disclosure. And I don't think that what we're talking about here has a place in financial statements. Its place is elsewhere. [Also included in 10(b)] **[TC 2/2, p. 31]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

With the exception of disclosure of management's forecasts and projections, the analysts generally confirmed that [the following] list of areas for improvement is both accurate and complete. In particular, most emphasized the importance of disaggregated information. In contrast, most of the analysts were uncertain about management's forecasts and projections. Many were concerned about whether they could ever rely on those forecasts. [Some believe] that analysts [themselves] should develop their own forecasts. [The list recommends:]

1. better disaggregated information.

2. more complete quarterly reporting. That is, interim reporting that more closely resembles annual reporting.
3. better identification and explanation of extraordinary, unusual, and infrequent items.
4. better information about measurement uncertainties, and operating opportunities and risks.
5. improved comparability and consistency in financial reporting methods over two business cycles, including disclosure of ten year summary information.
6. disclosure of the company's goals and objectives
7. better clarity in external reporting without reducing the amount of information.
8. disclosure of management's forecasts and projections.

[Also included in 11(c) and 15] **[GOLDMAN, p. ii-iii]**

Every analyst emphasized the critical role in their work of external financial reporting. They also affirmed the importance of audited financial statements.
[Also included in 11(c) and 15] **[GOLDMAN, p. iii]**

[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 1(b)] **[GOLDMAN, p. 1]**

Where the Art of Accounting Is Headed

12.15

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]

12.16 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	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]

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Table 2.7 (continued)

POSSIBLE FUTURE DEVELOPMENTS: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Data such as reporting of responses to social responsibilities will be required in financial reports														
Highly likely	4	–	5	3	*	*	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	–	*	–	–	–	–
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)?

	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 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]

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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	5	3	–	4	7	11	4	–	7	7	6	11	12
No answer	*	*	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	–	–	–	–	–	–	–	–	–	–	–

*Less than 5%

[HARRIS]

13. Nonfinancial Business Information, excluding Operating Opportunities and Risks

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	□

13. Nonfinancial Business Information, excluding Operating Opportunities and Risks

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]**

- "MD&A" information for nonpublic companies seeking capital would be helpful in assessing trends and understanding more about the enterprise and management's analysis of financial results. **[FASOversight, p. 2]**

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 5(a) and 10(b)] **[RMA92, p. 2]**

[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 1(c)] **[TOWERS PERRIN, p. 6]**

"[Companies] don't discuss problems candidly. They don't discuss the future of the company clearly." (Boston mutual fund analyst) [Also included in 2(a)] **[HILL KNOWLTON, p. 6]**

Professional investors . . . feel reports fall short in providing several kinds of information useful to their assessment of a company's future. These include management goals and strategy, research and development, competition, and the outlook. **[HILL KNOWLTON, p.10-11]**

Fifty-six percent of the professional sample agreed with the statement, "Annual reports all too often fail to clearly present management's goals and strategy." Representative comments: **[HILL KNOWLTON, p. 11]**

- "Discussing the goals of the company and management's strategy of achieving those goals would be very helpful. Also, comments on how close the company came to achieving its goals and why it fell short or exceeded them would be good." (Boston investment counseling firm analyst) **[HILL KNOWLTON, p. 11]**

- "I'd like more discussion of strategies and management objectives over the long term." (Philadelphia brokerage firm analyst) **[HILL KNOWLTON, p. 11]**

- "Annual reports should try to look forward, instead of backward. I'd like to see more discussion of strategies and how a company did in relation to the rest of the industry and the economy." (New York brokerage firm analyst) **[HILL KNOWLTON, p. 11]**

- "Annuals fail a lot on management strategy. Often, they just rehash what' been done in the company before. When that kind of sugar-coating happens, the 10-K becomes critical." (Chicago insurance group analyst) **[HILL KNOWLTON, p. 11]**

  Professionals gave 76 percent rating to describing R&D and product development efforts as a way for annual reports to be most useful. They gave clearly captioned pictures of new products and R&D processes a 57 percent rating in helping them size up a company. **[HILL KNOWLTON, p. 11]**

  Interestingly, 92 percent of the professional investors thought that annual reports all too often fail to present information on a company's competitive situation in its various businesses. (This information is currently required in the SEC-filed Form 10-K, but not in the annual report.) **[HILL KNOWLTON, p. 11]**

  Sixty-two percent of the professional sample agreed that annual reports fail all too often to clearly discuss the outlook for the current year. As a New York bank analyst commented: **[HILL KNOWLTON, p. 12]**

- "They could give a better, more realistic outlook for the coming year. I'd like to see management commit themselves to a certain course of action, and not just say, 'Well, we're expecting a bad year,' and that's all." **[HILL KNOWLTON, p. 12]**

  Addressing one kind of information that often helps in formulating a company's outlook, professionals gave a 76 percent rating to presenting data on trends in the company's industry and in the economy as a way for annual reports to be most useful. **[HILL KNOWLTON, p. 12]**

[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. [The] table [below] shows the types of information needed by the investors and the percentage of the respondents who consider each type of information important or extremely important. [Also included in 1(b)] **[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 frequently than the overall averages shown above.
3. There is no statistically significant difference between the first three items on the list, nor between the fourth through seventh items.

Source: SRI International survey, 1986.
[Also included in 1(b)] **[SRI, p. 30]**

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 1(b)] **[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 1(b)] **[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 as 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 1(b)] **[SRI, p. 30-31]**

"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 1(b)] **[SRI, p. 32]**

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 1(c)] **[SRI, p. 53&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), 1(c) and 17(f)] **[SRI, p. 53&55]**

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 1(b)] **[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. [Also included in 1(b)] **[PREVITS, p. 13]**

Labor productivity is also infrequently addressed [by sell-side analysts.] However, upcoming labor union negotiations are noted. [Also included in 1(b)] **[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 1(b)] **[PREVITS, p. 13-14]**

Additional analyst interest 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 1(b)] **[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(b) and 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[PREVITS, p. 15]**

The needs of analysts go beyond the historical cost, transition 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 1(a)] **[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 states. [Also included in 1(a)] **[PREVITS, p. 21]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. Throughout the meeting, investors mentioned the role of nonfinancial business information in their approach to evaluating equity securities and the current lack of adequate disclosure of nonfinancial business 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 3(a)] **[TI 10/16, p. 3]**

Participant I-6
The one thing that is missing with U.S. financial statements, much more than some of the Australian or Canadian financial statements, is the lack of production data that you need to get to those earnings numbers. In some foreign company reports, you find a lot more data behind the financial numbers. In a mining example, you know the production by quarter, the ore grades by quarter, the recovery rates; none of that is found in U.S. financial reporting. **[TI 10/16, p. 8]**

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 1(a)] **[TI 10/16, p. 16]**

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 1(b)] **[TI 10/16, p. 17]**

Participant I-11
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 1(b)] **[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 1(b)] **[TI 10/16, p. 18]**

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 1(b)] **[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 1(b) and 3(b)] **[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 1(b) and 3(a)] **[TI 10/16, p. 20-21]**

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 2(d)] **[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 2(d)] **[TI 10/16, p. 23]**

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 3(a)] **[TI 10/16, p. 25-26]**

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 1(b) and 2(d)] **[TI 10/16, p. 27]**

Participant I-1
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 1(b)] **[TI 10/16, p. 31-32]**

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 1(b)] **[TI 10/16, p. 45]**

Committee/Staff/Observer
Can you demand a copy of covenants to the company? [Also included in 1(b)] **[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 1(b) and 5(b)] **[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 1(b)] **[TI 10/16, p. 46]**

Participant I-1
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 5(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[TI 10/16, p. 48]**

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 1(c), 11(c), and 17(b)] **[TI 10/16, p. 51-52]**

Participant I-8
One information that would be useful would be days outstanding and inventory turnovers. **[TI 10/16, p. 52]**

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 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[TI 10/16, p. 53]**

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 2(d)] **[TI 10/16, p. 54]**

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 1(c)] **[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 1(c)] **[TI 10/16, p. 56]**

Committee/Staff/Observer
Coming back to [participant I-6]'s point about the lack of production data. Do you have an explanation for the fact that you find more disclosures of production data overseas than in the U.S. because, to my knowledge, those disclosures are not required anywhere? [Also included in 18(a)] **[TI 10/16, p. 59]**

Participant I-6
The only explanation I would have for it is that management of foreign companies tend to feel that it's a better way to communicate with shareholders on how they're growing the company. It is more readily available and more part of their financial disclosures and their presentations to the financial community overseas than it is here. Here, they focus on the financials more, which is very important, but in the basic industries it's hard to get to those numbers without understanding the production data. It seems that the companies here are very reluctant to disclose that information. [Also included in 18(a)] **[TI 10/16, p. 60]**

Participant I-2
You're also talking about situations where the extractive industry is a much more greater % of GNP than here. In the S&P 500, I think metals are maybe less than 1%. But if you're talking about South Africa or Australia, for example, it's a much bigger %; in Canada, gold is 5% of the S&P equivalent in Canada. [Also included in 18(a)] **[TI 10/16, p. 60]**

[Context] Responses to the postmeeting questionnaire to the October 16, 1992 Investor Discussion Group meeting.

QUESTION 4

The Committee has identified through its research to date four categories of business information about a company and its environment used by investors who follow the fundamental approach—the economy, the industry, the company, and segments of the company.

- Question 1: Please indicate the relative significance of each kind of information listed by entering the appropriate letter (right) in the first column of the table:

  E for Essential
  H for Helpful
  I for Merely Interesting
  N for Not Useful.

- Question 2: Please identify your source of each kind of information listed by entering the appropriate letter(s) (right) in the **second** column of the table:

X for **External Reporting**
G for **Government**
P for **Presentations by Management**
M for **Discussion with Management**
C for **Discussion with Competitors, Customers, or Suppliers**
T for **Industry or Trade Associations**
O for **Other. Please identify**

- Question 3: For information not provided by external reporting, 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 appropriate letter (right) in the **final** column of the table:

S for **Existing Sources Satisfactory**
V for **Company not Best Source for Verifiability Reasons**
H for **Disclosure that could Harm the Company's Competitive Position**
B for **Cost to Company Exceeds the Benefits of the Information**
R for **Redundant**
O for **Other. Please identify**

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	Question 3 No	Question 3 Explain No
General economy:					
● Social, demographic, technological, political, and regulatory trends	*Essential:* 3	X-2;G-3;P-3; M-2;C-2;T-3		1	S-1;V-1; B-1
	Helpful: 6	X-1;G-3;P-1; M-3;C-2;T-3; 0-1	1	4	S-2;V-2
● Historical macroeconomic data for period under analysis—usually two business cycles—and projected macroeconomic data for one or two business cycles					
◆ Real gross product	*Essential:* 2	G-2; P-1; C-1; T-1		1	R-1
	Helpful: 4	G-4;T-2;O-1		3	V-1;B-2
	Interesting: 3	G-3;O-1		3	S-2;V-1
◆ Major expenditure components of gross product, for example, personal consumption expenditures for durable goods, nondurable goods, and services	*Essential:* 2	G-2; P-1; C-1; T-1		1	R-1
	Helpful: 5	G-5;T-2;O-1		4	S-1;V-1; B-2
	Interesting: 2	G-2;O-1		2	S-1;V-1
◆ Employment	*Essential:1*	G-1;P-1;C-1; T-1			
	Helpful: 6	G-6;T-2;O-1		5	S-1;V-1; B-2;R-1
	Interesting: 1	G-1		1	S-1
	Not Helpful:1	G-1;O-1		1	V-1
◆ Productivity	*Essential:* 1	G-1;P-1;C-1; T-1			
	Helpful 5	G-5;T-2;O-1		4	V-1;B-2; R-1
	Interesting: 2	G-2		2	S-2
	Not Helpful:1	G-1;O-1		1	V-1
◆ Timing and amplitude of business cycles	*Essential:* 1	G-1;P-1;C-1; T-1			
	Helpful: 6	G-6;T-2;O-1		5	S-1;V-1; B-2;R-1
	Interesting: 1	G-1		1	S-1
◆ Monetary and fiscal policy	*Essential:* 2	G-2;P-1;C-1; T-1		1	R-1
	Helpful: 6	G-1		5	S-1;V-2; B-2
	Interesting: 1	G-6;T-2;O-2 G-1		1	S-1
◆ Inflation	*Essential:* 3	G-3;P-1;C-1; T-1		2	S-1;R-1
	Helpful: 5	G-5;T-2;O-2		4	V-2;B-2
	Interesting: 1	G-1		1	S-1

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	No	Explain No
General economy (continued):					
◆ Interest rates (including risk-free rates and risk premiums)	*Essential:* 2	G-2; P-1; C-1; T-1		1	S-1
	Helpful: 6	G-6;T-2;O-2		5	V-2;B-2;R-1
	Interesting: 1	G-1		1	S-1
◆ Tax rates and policy	*Essential:* 1	G-1: P-1; C-1; T-1			
	Helpful: 7	G-7;T-2;O-2		6	S-1;V-2; B-2;R-1
	Interesting: 1	G-1		1	S-1
Each industry in which company participates or plans to participate:					
● Definition of industry	*Essential:* 6	G-1;X-4;P-6; M-5;C-1;T-1	4	1	S-1
	Helpful: 1	G-1;M-1; C-1;T-1			
	Interesting: 2	P-1;M-1;C-1		1	S-1
● Shifts in boundaries of industry (resulting from economic, social, demographic, technological, political, and regulatory trends)	*Essential:* 5	X-2;G-2;P-4; M-3;T-4;C-1	2	2	S-1;V-1
	Helpful: 3	X-1;G-1;P-1; M-2;C-1;T-1	1		
	Interesting: 1	X-1;P-1;M-1; C-1		1	S-1
● Industry structure and outlook					
◆ Industry trends and outlooks	*Essential:* 9	X-5;G-3;P-8; M-8;C-5;T-8; O-1	3	3	S-3; V-1;H-1
◆ Ability of new companies to enter industry	*Essential:* 4	X-2;G-3;P-2; M-3;C-3;T-3; O-1		2	S-1;V-2; H-1
	Helpful: 5	X-1;P-3;M-5; C-2;T-4	2	3	S-1;B-1; O-1
◆ Ability of substitute products or services to displace industry's	*Essential:* 9	X-3;G-3;P-7; M-8;C-6;T-6; O-1		7	S-2;V-2; H-3;O-1
◆ Resources (sources and availability; relative bargaining power of resource providers)	*Essential:* 3	X-1;G-3;P-2; M-2;C-3;T-3; O-1		1	S-1;V-1; H-1
	Helpful: 5	X-1;P-2;M-3; C-2;T-3		5	S-1;V-1; H-2
◆ Customers (number, names, and bargaining power of dominant customers participating in industry's market)	*Essential:* 7	X-4;G-3;P-2; M-4;C-5;T-4; O-1	3	2	S-2;V-1; H-1
	Helpful: 1	P-1;M-1		1	O-1
	Interesting: 1	M-1			H-1

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	No	Explain No
Each industry in which company participates or plans to participate (continued):					
◆ Competitors (number and names of and intensity of rivalry among major competitors within industry) and their positions within industry (trends in their market shares, relative profitability, resources, and competitive advantages and disadvantages)	*Essential:* 9	X-2;G-3;P-4; M-8;C-6;T-6; O-1	2	5	S-2;V-2; H-3;O-1
Company:					
● Historical and projected aggregate financial and operating data for industry	*Essential:* 6	X-3;P-4;M-4; C-1; T-3	2	2	R-1;O-1
	Helpful: 2	X-1;G-1;P-2; M-1;C-1;T-2	1	1	B-1
● Mission and intent (company's purpose in general terms and its long-term intent)	*Essential:* 6	X-3;P-4;M-6; C-1;T-1	4		
	Helpful: 1	P-1;M-1	1		
	Interesting: 1	M-1		1	S-1
● Strategy and strategic alignment					
◆ Business strategy	*Essential:* 8	X-4;P-7;M-8; C-1;T-1	5	1	S-1
◆ Consistency of strategy with external trends (economic, social, demographic, technological, political, regulatory, and industry)	*Essential:* 6	X-3;G-1;P-5; M-6;C-2;T-2	1	3	H-1;O-2
	Helpful: 3	P-3;M-3	2	1	S-1
◆ Consistency of strategy with managerial approach (operations; allocation of resources; and director, management, and employee incentives)	*Essential:* 8	X-5;P-6;M-7; C-2	4	2	V-1;H-1
	Helpful: 1	P-1;M-1		1	S-1
● Ability to innovate, adapt to change, and continuously improve					
◆ Enabling infrastructure (organizational structure, business strategy, management philosophy, and employee incentives)	*Essential:* 6	X-3;P-4;M-5; C-3	2	2	S-1;B-1
	Helpful: 3	P-3;M-3	2	1	H-1
◆ Recent process, product, or service innovations; sources and consequences	*Essential:* 6	X-4;P-3;M-5; C-3;T-2	3	1	S-1
	Helpful: 3	X-3;P-3;M-3	2	1	H-1
◆ Recent changes in environment; nature and timing of company's response	*Essential:* 7	X-5;P-4;M-6; C-4;T-4	5		
	Interesting: 1	X-1;P-1;M-1		1	H-1
◆ Rate of change in company's performance (key operating and financial measures; trend in rate of change; reasons for that trend)	*Essential:* 7	X-5;P-5;M-6; C-3	4	1	O-1
	Helpful: 2	X-2;P-2;M-2	2		
● Competitive advantages and disadvantages (identity, source, and sustainability)	*Essential:* 7	X-3;P-6;M-7; C-5;T-2	1	4	S-1;V-1; H-2;O-1
	Helpful: 2	P-2;M-2		2	H-2;B-2
● Opportunities and risks managed at company level					

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	No	Explain No
Company (continued):					
◆ Prospect of participation in additional industries; resulting impact on company	*Essential: 6*	X-2;P-5;M-6; C-3; T-1	1	3	H-3
	Helpful: 3	X-1;P-3;M-3; C-1	1	2	H-2;B-1
◆ Opportunities and risks resulting from concentrations (for example, in company's assets, customers, or suppliers)	*Essential: 5*	X-2;P-4;M-5; C-2;T-1	2	1	H-1
	Helpful: 4	X-1;P-3;M-4; C-1	1	3	H-3
◆ Risk of illiquidity	*Essential: 6*	X-5;P-5;M-6; C-2;T-1	4		
	Helpful: 2	X-2;P-1;M-2	1	1	H-1;B-1
◆ Contingent gains and losses related to company's assets and liabilities	*Essential: 6*	X-4;P-5;M-6; C-2;T-1	4		
	Helpful: 3	X-3;P-2;M-3; T-1	2	1	H-1;B-1
● Historical data about company (for period under analysis, often two business cycles)					
◆ Financial data (financial position, income, and cash flows)	*Essential: 7*	X-5;P-4;M-5; G-1;C-1;T-1	5		
	Helpful: 2	X-2;T-2	2		
◆ Nonfinancial operating data	*Essential: 4*	G-1; X-3;P-2; M-3; C-1;T-2	2		
	Helpful: 4	X-4;P-3;M-3; C-1;T-1	3		
◆ Identity of key trends and relationships among data and reasons that those trends and relationships related to company differed from those related to competitors, industry, or economy to provide insight about the company's strategy and strategic alignment; its ability to innovate, adapt to change and continuously improve; identification and sustainability of its competitive advantages and disadvantages; opportunities and risks; and cash flows	*Essential: 7*	X-3;G-2;P-6; M-7;C-2;T-2; O-1	2	2	V-1;O-1
	Helpful: 2	G-2;T-2		2	V-2;B-2
● Prospective data about company					
◆ Cash flows (cash from operations, from investments to support operations, from nonoperating investments, and for servicing debt)	*Essential: 6*	X-2;P-3;M-4; C-2;T-1	2	1	O-1
	Helpful: 2	X-1;P-1;M-1		1	B-1
	Interesting: 1	X-1;P-1;M-1		1	B-1
◆ Stock value	*Essential: 3*	P-1;M-2;C-2; T-1		1	
	Helpful: 3	X-1;T-2		3	V-1;B-1; O-1
	Interesting: 1	O-1		1	V-1
	Not Useful: 1			1	

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	No	Explain No
Each industry segment within company					
● Description of business of segment					
◆ Principal products and services	*Essential: 9*	X-6;P-7;M-8; C-1;T-1	6	1	S-1
◆ Principal market served by products and services; size of market	*Essential: 9*	X-5;P-7;M-8; T-4;C-3	5	2	S-1;V-1
◆ Process used to make product or provide service	*Essential: 5*	X-2;P-3;M-4; C-1;T-1	1	2	S-1;B-1
	Helpful: 3	X-1;P-3;M-3; T-2	3		
	Interesting: 1			1	H-1
◆ Key inputs to process	*Essential: 5*	X-2;P-3;M-4;C-1;T-1	1	2	S-1;B-1
	Helpful: 3	X-1;P-3;M-3 T-2	3		
	Not Helpful: 1	M-1		1	H-1
◆ Distribution methods for products and services	*Essential: 6*	X-2;P-4;M-5; C-1;T-1	2	2	S-1;B-1
	Helpful: 3	X-1;P-3;M-3; T-1	2	1	H-1
◆ Seasonality and cyclicality	*Essential: 7*	X-3;P-5;M-6; C-1;T-3	3	2	S-1;B-1
	Helpful: 2	X-1;P-2;M-2	2		
◆ Regulation and legislation affecting segment	*Essential: 8*	X-5;G-1;P-6; M-7;C-2;T-4	5	1	B-1
	Helpful: 1	P-1;M-1		1	S-1
◆ Importance of patents, trademarks, licenses, franchises, and concessions held	*Essential: 6*	X-3;P-4;M-5; C-2;T-1	4		
	Helpful: 3	X-1;P-3;M-3		3	H-1;B-2
● Mission and intent of segment	*Essential: 8*	X-5;P-6;M-7; C-1;T-1	6		
	Interesting: 1	P-1;M-1		1	S-1
● Strategy and strategic alignment					
◆ Business strategy	*Essential: 9*	X-7;P-8;M-9; C-2;T-1	5	1	S-1
◆ Relationship between company's and segment's strategies	*Essential: 7*	X-6;P-6;M-7; C-1;T-1	4		
	Helpful: 2	P-2;M-2;C-1	1	1	O-1
◆ Consistency of strategy with external trends (economic, social, demographic, technological, political, regulatory and industry)	*Essential: 4*	X-2;P-3;M-4; C-2;T-2	1	1	V-1
	Helpful: 5	X-3;P-5;M-5		4	B-1;S-2; O-1

Question 4 (continued)

	Question 1 Significance		Question 2 Sources	Question 3 Yes	Question 3 No	Question 3 Explain No
Each industry segment within company (continued)						
◆ Consistency of strategy with managerial approach (operations; allocation of resources; director, management, and employee incentives)	*Essential:*	*6*	X-4;P-4;M-5; C-1;T-1	1	3	V-1;H-1; O-1
	Helpful	*3*	X-2;P-3;M-3	2	1	S-1
● Position within industry						
◆ Market share and trend in market share	*Essential:*	*7*	X-3;P-6;M-7: C-3;T-4	3	2	V-1;H-1; R-1
	Helpful:	*2*	X-2;G-1;P-2; M-2;C-1;T-1	1	1	V-1;H-1
◆ Number of competitors and names of major competitors	*Essential:*	*4*	X-2;P-3;M-4; C-2;T-3	2		
	Helpful:	*5*	X-2;P-3;M-5; C-2;T-3	2	3	V-2;B-1; R-1
◆ Relative profitability and resources of competitors	*Essential:*	*5*	X-2;P-3;M-5; C-3;T-4		3	V-1;B-1 R-1
	Helpful:	*3*	X-1;P-2;M-3; C-2;T-2		3	V-3;H-1; B-1
	Interesting:	*1*	P-1;M-1;T-1		1	V-1;B-1
◆ Relative competitive advantages and disadvantages (identity, source, and sustainability)	*Essential:*	*5*	X-2;P-4;M-5; C-3;T-3	1	2	V-1;H-1; R-1
	Helpful:	*4*	X-1;P-4;M-4; C-2;T-2		4	V-3;H-1; B-3
● Ability to innovate, adapt to change, and continuously improve						
◆ Enabling infrastructure (organizational structure, business strategy, management philosophy, and employee incentives)	*Essential:*	*4*	X-3;P-3;M-4; C-1;T-1			
	Helpful:	*2*	X-1;P-2;M-2	1	1	S-1
	Interesting:	*3*	P-2;M-3		3	S-1;V-2; B-2
◆ Recent process, product, or service innovations; sources and consequences	*Essential:*	*6*	X-4;P-5;M-6; C-3;T-1	2	2	S-1;H-1; B-1
	Helpful:	*2*	P-2;M-2		2	V-2;B-2
	Interesting:	*1*	M-1		1	S-1
◆ Recent changes in environment; nature and timing of segment's response	*Essential:*	*7*	X-5;P-6;M-7; C-2;T-4	5		
	Interesting:	*1*	M-1		1	S-1
◆ Rate of change in segment's performance (key operating and financial measures; trend in rate of change; reasons for that trend)	*Essential:*	*6*	X-4;P-4;M-5; C-2;T-2	4		
	Helpful:	*3*	X-3;P-2;M-2	3		

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	No	Explain No
Each industry segment within company (continued)					
● Opportunities and risks managed at segment level					
◆ Prospective changes in segment's industry attractiveness (broad social, demographic, technological, political, regulatory, and other trends that affect the segment; and industry trends including changes in relative costs, improvements in existing products or services, introductions of successful new products or services, and development of specific sectors of market)	*Essential:* 6	X-4;G-1;P-5; M-6;C-3;T-4	2	1	V-1
	Helpful: 3	P-3;M-3;T-1		3	V-3;B-2
◆ Opportunities and risks resulting from concentrations (assets, customers, or suppliers)	*Essential:* 5	X-3;P-4;M-5; C-1;T-1	2	1	H-1
	Helpful: 4	X-3;P-3;M-3; C-1;T-2	4		
◆ Risk of illiquidity	*Essential:* 7	X-5;P-6;M-7; C-1;T-1	5		
	Helpful: 2	X-2;P-1;M-1; C-1;T-1		1	V-1
◆ Contingent gains and losses related to company's assets and liabilities	*Essential:* 5	X-3;P-4;M-5; C-1;T-1	3		
	Helpful: 4	X-4;P-3;M-3	3	1	H-1
◆ Physical resources	*Essential:* 7	X-5;P-6;M-7	4	1	H-1;B-1
	Helpful: 1	X-1;P-1;M-1			
	Interesting: 1	X-1		1	B-1
◆ Factors that increase or decrease financial value	*Essential:* 4	X-2;P-3;M-4; C-1;T-1	2		
	Helpful: 4	X-2;P-4;M-4		3	V-2;B-2; O-1
	Not Useful: 1			1	
● Historical data about segment (for period under analysis, often two business cycles)					
◆ Financial data	*Essential:* 8	X-6;P-6;M-7; C-1;T-1	5		
	Helpful: 1	X-1			
◆ Nonfinancial operating data	*Essential:* 5	X-4;P-3;M-4	3		
	Helpful: 2	X-2;P-2;M-2; C-1;T-1	1		
	Interesting: 1	X-1			

Question 4 (continued)

	Question 1 Significance	Question 2 Sources	Question 3 Yes	Question 3 No	Question 3 Explain No
Each industry segment within company (continued)					
◆ Identity of key trends and relationships among data and reasons that those trends and relationships differed from those related to competitors, industry, or economy to provide insight about the segment's strategy and strategic alignment; its ability to innovate, adapt to change and continuously improve; its competitive advantages and disadvantages; opportunities and risks; and cash flows	*Essential:* 8	X-5;G-1;P-6; M-7;C-2;T-2	4	1	V-1
	Interesting: 1	X-1;M-1;C-1		1	H-1
● Prospective data about segment (for one or two business cycles)					
◆ Cash flows	*Essential:* 6	X-2;P-3;M-4; C-2;T-2	2	1	O-1
	Helpful: 1	X-1;P-1;M-1; T-1		1	V-1;B-1
	Interesting: 2	X-1;P-1;M-1		2	V-1;B-1 O-1
◆ Nonfinancial and operating data	*Essential:* 5	X-1;P-2;M-3; C-1;T-1	2	1	O-1
	Helpful: 3	X-2;P-3;M-3; C-1;T-1	1	1	V-1;B-1
	Interesting: 1	X-1		1	O-1

[PMQI 10/16, p. 14-23]

[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, investors commented on the MD&A.

Committee/Staff/Observer
[T]he 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 2(b) and 10(b)] **[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 2(b) and 10(b)] **[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 2(b) and 10(b)] **[TI 1/13, p. 49]**

Participant I-11
Yes, the MD&A provides a promising starting point. But I think that in the vast majority of cases, the present MD&A is a joke. There is a vehicle there that could be used to do what it's supposed to do, but it sure isn't being used for that now. The bad news about the MD&A is that it is an SEC-required thing and it tends to be filled at the lowest possible level. [Also included in 10(b)] **[TI 1/13, p. 49]**

Participant I-8
I'm not aware of one instance where the SEC has challenged even after the fact what a company wrote in an MD&A. [Also included in 10(b)] **[TI 1/13, p. 49]**

Committee/Staff/Observer
They have. [Also included in 10(b)] **[TI 1/13, p. 49]**

Committee/Staff/Observer
Do you think that the filling out to the lowest level would change if it were an accounting standard versus an SEC requirement? [Also included in 10(b)] **[TI 1/13, p. 49]**

Participant I-11
I think there would be a better chance of it. The idea behind the MD&A was clearly a good one, the execution clearly has been a failure. It seems to me that over the years the accounting profession has had a little more leverage in getting some of these changes effected than the SEC has had. [Also included in 10(b)] **[TI 1/13, p. 49]**

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 3(a) and 10(b)] **[TI 1/13, p. 50]**

Participant I-12
I've had companies tell me that if they didn't write the MD&A that way, it would take months to get the annual report out of the SEC. The SEC is looking for certain types of descriptive phrases; it's boilerplate. Part of the reason the MD&A is not that useful, a good structure but not that useful, is because we're looking at accounting items that are not necessarily the relevant ones. Perhaps it would be better if the MD&A evolves into more disclosures about lines of business. [Also included in 10(b)] **[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 auditor involvement. During the discussion, comments were made on the MD&A.

Participant I-16
There is generally nothing in the MD&A that concerns me at all; it is generally a meaningless statement. Auditing it doesn't make any difference. [Also included in 17(b)] **[TI 3/17, p. 20]**

Participant I-11
The MD&A should be a discussion by management of the operating events that produce the financial statements. We all know that's not what it usually is. It's usually a regurgitation of the numbers. Similarly, the AD&A would be the auditors' discussion of the way the accounting principles and techniques were applied to the operating events to produce the financial statements. In that context, I think it's appropriate to have the auditors involved in estimates. For example, taking the real estate portfolio example, the balance sheet shows that on the balance sheet date there was an asset called real estate portfolio, and the value assigned to that asset was reached by making certain assumptions or estimates. In order to judge the accuracy of that figure, a user needs to have an idea of what those estimates were. As far as estimates in the future are concerned, I think [participant I-12] is right; that is what we're doing and I don't get any additional comfort by having an auditor tell me that management's estimates are good or bad because I'm making my own anyhow. A few years ago, when [name deleted] tried to do a big deal based on some projections of air travel that had factors and yields going nothing but up, that deal never got done because independent financial analysts said the assumptions were preposterous. [Also included in 12, 17(b), and 17(c)] **[TI 3/17, p. 21]**

[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 nonfinancial business information.

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 1(b)] **[TC 12/8, p. 50]**

Participant C-5

The items that we are always looking for are projections on 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 1(b) and 12] **[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 1(b) and 12] **[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 1(b) and 12] **[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 1(b)] **[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 1(b)] **[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 1(b) and 3(c)] **[TC 12/8, p. 51-52]**

Committee/Staff/Observer
Do you track backlog as opposed to getting it once a year? [Also included in 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b), 11(c), 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 1(b)] **[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 1(b)] **[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 1(b)] **[TC 12/8, p. 53]**

Committee/Staff/Observer
Let me launch just a second tier inquiry, then. Things 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 1(b)] **[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 1(b)] **[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 1(b)] **[TC 12/8, p. 54]**

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 1(c) and 12] **[TC 12/8, p. 69]**

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 1(c) and 12] **[TC 12/8, p. 70]**

Participant C-12
It 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 are 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 1(c) and 12] **[TC 12/8, p. 70-71]**

[Context] Responses to the postmeeting questionnaire to the December 8, 1992 Creditor Discussion Group meeting.

QUESTION 8

Participants frequently referred to discussions with management as an important source of information. Below are several categories of information which could be a topic of discussion with management. For each please indicate:

<u>Frequency of Discussion</u> -- **A** - Always
F - Frequently
O - Occasionally, if something unusual has occurred
N - Never

<u>Importance of Reliability</u> - **V** - Very Reliable Information is needed
S - Somewhat Reliable Information is needed
L - Low Reliability, Management's Opinion is Sufficient

13. Nonfinancial Business Information, excluding Operating Opportunities and Risks—Page 28

	FREQUENCY				RELIABILITY		
	A	F	O	N	V	S	L
General economy:							
•Social, demographic, technological, political and regulatory trends	5	4	6	1	1	6	9
•Historical macroeconomic data for period under analysis—usually two business cycles—and projected macroeconomic data for one or two business cycles (employment, inflation, real gross product, etc.)	3	4	8	1	4	4	6
Each industry in which company participates or plans to participate							
•Definition of industry	4	6	6		3	8	4
•Shifts in boundaries of industry (resulting from economic, social, demographic, technological, political, and regulatory trends)	4	5	7		3	9	3
•Industry structure and outlook (for example example, ability of new companies to enter industry, customers, competitors, etc.)	6	7	3		6	7	2
•Historical and projected aggregate financial and operating data for industry	3	7	3	3	3	8	3
Company							
•Mission and intent (company's purpose in general terms and its long-term intent)	10	3	2	1	7	3	5
•Strategy and strategic alignment (business strategy, consistency of strategy with external trends, etc.)	11	5	1		9	5	
•Ability to innovate, adapt to change, and continuously improve	4	8	2	2	1	7	3
•Competitive advantages and disadvantages	10	5	2		5	10	1
•Opportunities and risks managed at company level	9	5	2		2	10	2
•Prospective data about company	9	6	1		4	9	1
Each industry segment within company:							
•Description of business segment	6	7	3		5	5	4
•Mission and intent of segment	6	4	6	1	5	5	5
•Strategy and strategic alignment (business strategy, consistency of strategy with managerial approach)	7	6	3	1	4	7	4
•Position within industry	6	5	5		5	7	3
•Ability to innovate, adapt to change, and continuously improve	2	6	6	2	3	7	4
•Opportunities and risks managed at segment level	3	9	4	1	2	11	3

•Historical data about segment (for period under analysis, often two business cycles)	**7**	**6**	**3**	**1**	**10**	**4**	**1**
•Prospective data about segment (for one or two business cycles)	**5**	**7**	**3**	**1**	**3**	**8**	**3**

Participant C-3 - Ability to innovate, adapt to change, and continuously improve has to be observed - not asked.

Participant C-14 - Always want reliable information?

Participant C-15 - Historical data about segment (for period under analysis, often tow business cycles) - 5 years.

Participant C-10 - A lot of this data we desire but we don't get insight into all of these topics in any one meeting with management. We feed on all little tidbits that come out of conversations and put them together judgmentally and make our investment decisions from there.

Participant C-12 - Ability to innovate, adapt to change, and continuously improve has to be observed - I never ask management this.

Participant C-5 - Under the General Economy - second bullet and Each Industry In Which Company Participates Or Plans To Participate - fourth bullet: Other Sources.

Participant C-18 - Historical and projected aggregate financial and operating data for industry - Historical - V and Projected - S.

Participant C-11 - I am bothered by "low reliability" in the question. The information can be very reliable and the intentions, but the outcome can be uncertain because of unknown future conditions. These are two different things that any analyst should understand.

Participant C-9 - An operating group may report mission, strategy or results - yet may cover various diverse products. Due to nature of financial reporting - may not have any conclusive BS or income statement data on either operating group or product. *Under the General Economy - second bullet:* Use external reports. *Each Industry In Which Company Participants Or Plans To Participate - fourth bullet:* Information not available publicly. *Each Industry Segment Within Company - seventh and eighth bullets:* Current segment definition doesn't add value to financial institutions analysis.
[PMQC 12/8, p. 18-20]

[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 nonfinancial business information.

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 5(a)] **[TC 2/2, p. 13]**

Participant C-17
Kinds of stuff that would come to my mind [for disclosure] 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 5(b) and 17(a)] **[TC 2/2, p. 19-20]**

[Context] Responses to the postmeeting questionnaire to the February 2, 1993 Creditor Discussion Group meeting.

QUESTION 15—Management's Discussion & Analysis (MD&A) [Also included in 10(d)]

We recognize that private companies do not provide MD&A's, at least not according to a regulaton requirement. Consequently, creditors lending principally to private companies may have limited concerns or opinions regarding the SEC-required MD&A disclosures. *If you serve private companies, please pay particular attention to item (d) below.*

For public companies, the discussion at the meeting left the Committee with the impression that some members of the group felt that improvements could be made in implementing current MD&A requirements.

a. Current MD&A disclosures in annual reports generally fall short of user expectations.

_ AGREE 11 _ DISAGREE 3

Participant C-2: Neutral, depends on quality and candor of report.

If AGREE, please indicate your view of the following (**SA** - Strongly Agree, **A** - Agree or **D** - Disagree):

___SA-2,A-5,D-3 Current MD&A's tend to use too much cautious legal language instead of straight-forward descriptions of the pertinent events, circumstances, trends, commitments, and uncertainties that are likely to make the company's future different from its past.

___SA-2,A-8,D-1 Current MD&A's tend to repeat the same descriptions from period to period, merely changing the numbers instead of focusing on events, opportunities and risks which may be new in a particular period.

___SA-1,A-6,D-4 Current MD&A's tend to overemphasize opportunities and remain mostly silent about potential risks.

___ Other. Please describe

Participant C-14: Lack of specific discussion on cooperative strategy and alternative financial objectives.

Participant C-11: Lawyers and bureaucrats are the enemy. Rather than just repeating the numbers, the MD&A should provide an analysis of events in the period - written from the CFO perspective. This is not something that AICPA or anyone else can legislate.

Participant C-15: Because of legal liabilities resulting from these disclosures, e.g., CAT, these should improve over time but lawyers will have greater impact.

[Also included in 10(d)] **[PMQC 2/2, p. 26]**

d. From time to time, users have proposed that *private companies* should provide disclosures similar to MD&A. Please indicate your reactions to the following using:

SA Strongly Agree
A Agree
N Neutral
D Disagree
SD Strongly Disagree

MD&A disclosures for private companies would significantly improve their financial reporting.

SA	A	N	D	SD
4	6	1	1	

Participant C-18: It would be a joke. You would never again see an audited financial statement.

While MD&A disclosures for private companies would be desirable, the costs of providing the information would be of greater concern than the value of receiving the information.

SA	A	N	D	SD
4	1	2	2	1

Participant C-2: What is the cost typically? Hard to judge...

If MD&A disclosures are provided by private companies, the detailed disclosure requirements should be the same as those for public companies.

SA	A	N	D	SD
3	4		4	2

Comments

Participant C-17: I believe it would be helpful but the cost would drive too many away. Direct access to the customer would allow each creditor to seek their own level of disclosure.

Participant C-13: I do not deal with private companies. My assumption is that private companies, in order to get financing, provide investors and creditors with more information in a discussion mode, than public companies.

Participant C-2: MD&A disclosures raise issues that might not automatically come to a lender's attention. Then the lender can seek out additional information. Would be particularly valuable in evaluating a new borrower.

Participant C-4: Standardizing MD&A reporting can provide a basis for further discussion with management of private companies. It would also provide a framework of required disclosure that could be useful in comparative analysis.

Participant C-14: Probably a useful exercise for management.

Participant C-11: I defer to other panelists in general. However, the term "private company" is misleading. We have some private placement investments where the companies are large enough so that we can insist that an MD&A - type discussion is justified.

[Also included in 10(d)] **[PMQC 2/2, p. 28-29]**

[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 MD&A.

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 1(b) and 17(b)] **[TC 3/11, p. 22]**

Participant C-15
[Participant C-12] do you think that you would get as much information out of the MD&A section if it was audited as if it wasn't audited? Some of the discussion is real helpful; do you think that might be sort of reduced if the auditors had to sign off on that? [Also included in 17(b)] **[TC 3/11, p. 23]**

Participant C-1
I would hate to lose the information and the facts that are in the MD&A because they all of a sudden have to be audited. For example, discussion of the estimated impact of a strike or a plant closure that wouldn't necessarily be broken out in the normal financial statements. While I think it would be great if auditors looked at that, I'd hate to lose it because it is such an important way that we look at companies. [Also included in 17(b)] **[TC 3/11, p. 24]**

Committee/Staff/Observer
Is it your impression that the auditors now do not look at the MD&A's? [Also included in 17(b)] **[TC 3/11, p. 24]**

Participant C-1
No, it's my impression on talking to companies that they will put stuff in the MD&A that, if you read it carefully, will answer your question in terms of one-time charges, that can not be broken down in the financial statements. [Also included in 17(b)] **[TC 3/11, p. 24]**

Participant C-11
I know that they have always been told by the companies that the auditors review the MD&A type information. I think that's excellent. I would be nervous about making it a formal

requirement, and I don't think accountants should in effect write the MD&A. I want to know about the company's business strategy; I'd hate to lose that information. [Also included in 17(b)] **[TC 3/11, p. 25]**

Participant C-10
You earlier asked me if I agreed with the point about extending the audit to the MD&A. I would just say that I really like the MD&A. We all use it. The question is how do we keep it as valuable as it is, and if anything, have the auditors help increase that value. But at the same time not put limitations on it. [Also included in 117(b)] **[TC 3/11, p. 25]**

Committee/Staff/Observer
Would you want an MD&A for private and smaller companies? [Also included in 2(d) 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 2(d) and 17(b)] **[TC 3/11, p. 25]**

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 2(d)] **[TC 3/11, p. 26]**

[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 nonfinancial business information.

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 5(a) 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 22 - MD&A

On paper, the Management Discussion and Analysis (MD&A) prescribed by the Securities and Exchange Commission promises to be a valuable source of information about a company's operating opportunities and risks. It is supposed to cover at least liquidity, capital resources, and results of operations and to focus on material events and uncertainties known to management that would cause the reported information not necessarily to be a good indicator of future operating results or future financial position, for example:

- Events and circumstances that would affect future operations but did not affect past operations
- Events and circumstances that have affected past operations but are not expected to affect future operations
- Known events or circumstances that would change the trend of, or vary the relationships between, revenues and expenses
- Known trends or known demands, commitments, events, or uncertainties that will or are reasonably likely to increase or decrease materially the company's liquidity
- Known trends or uncertainties that have had or management reasonably expects will have a material favorable or unfavorable effect on net sales or revenues or income from continuing operations.

Causes of changes in line items are to be sufficiently described to provide an understanding of the business as a whole.

The discussion at the meeting, however, left the Committee with the impression that many members of the group generally gave MD&A high marks for conception but much lower grades in practice. Please check the applicable boxes to identify the statements with which you most agree.

a. The MD&A generally does not live up to its promise	*5*
b. The MD&A provides a starting point for disclosing needed information about a company's operating opportunities and risks but needs to be changed to overcome the kinds of weaknesses described in (a) below	*6*
c. The MD&A generally provides needed information about a company's operating opportunities and risks and should be incorporated into a company's external reporting	

If you checked (a)—The MD&A generally does not live up to its promise—please indicate the reason(s) for your choice by checking the applicable box(es) and, if needed, writing an explanation in the space provided [please skip if you did not check (a)]

Companies tend to follow the letter rather than the spirit of the rule—to use legal expressions known by company legal counsel to be acceptable to or favored by the Commission instead of straight-forward descriptions of the pertinent events, circumstances, trends, commitments, and uncertainties that are likely to make the company's future different from its past	*5*
Companies tend to repeat essentially the same descriptions from period to period, merely changing the numbers, instead of focusing on the most relevant operating opportunities and risks, which may be new in a particular period	*5*
Companies tend to overemphasize opportunities and remain mostly silent about potential risks	*3*
Other. Please describe *Participant I-11*: Descriptions tend to be symptomatic, not diagnostic or prognastic, i.e., "sales increased because we sold more units at higher prices, cost of goods increased because we sold more goods, gross profit increased because sales in dollars were up more than cost of goods in dollars."	*1*

Participant I-12: Last few years- seeing general improvements.

If you checked (b)—The MD&A provides a starting point for disclosing needed information about a company's operating opportunities and risks but needs to be changed to overcome the kinds of weaknesses described in (a)—please describe briefly the major improvements needed [please skip if you did not check (b)]

Participant I-6: A real discussion of events during the period covered. Not just a ...of changes by line item in the financial statements but why and what caused the change.
Participant I-7: To general and little emphasis on risks of a major nature
Participant I-9: You cannot ask managements to "bare their souls" and share their innermost concerns with outsiders. What you want is for the management to put you on notice if they know something important that is not generally known. Examples - they are not taking bills on time or collecting receipts as scheduled, their biggest customer is cancelling its contract, a competitor is doubling capacity, currency fluctuations will lead to significant price increases, etc.
Participant I-10: Focus on opportunities.
Participant I-11: Meaningful analysis: "Sales increased 10% because of a 2% average price increase and an 8% increase in unit volume. Growth in the market accounted for 4% of the volume increase, increased market penetration accounted for 2% and new products accounted for 2%." (I recognize this sort of precision often is not possible. The point is, analyze, don't obfuscate.)
Participant I-12: 1)Why a given line item changed (units, prices, economic events), 2) Business segment/geographic factors that affected the results, 3) Specific management actions that affected results.

If you checked (c)—the MD&A generally provides needed information about a company's operating opportunities and risks and should be incorporated into a company's external reporting—please write any additional comments you may have on the MD&A and its use in external reporting [please skip if you did not check (c)]
[PMQI 12/9 and 1/13, p. 43-45]

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), 5(b), 11(a), 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 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), 5(d), 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 5(d)] **[AIMR/CIC92, p. 4]**

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), 3(e), 5(b), 10(c), 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 3(e)] **[KPMG BANK STUDY, p. 38]**

- Disclosures 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 5(b)] **[KPMG BANK STUDY, p. 38]**

- Management discussion of asset/liability management and credit quality [Also included in 10(c)] **[KPMG BANK STUDY, p. 39]**

- Examiner findings and comments [Also included in 17(f)] **[KPMG BANK STUDY, 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(b), 5(c), and 5(d)] **[KPMG BANK STUDY, p. 39]**

- Wanted detailed explanations of methodologies and significant assumptions [Also included in 4] **[KPMG BANK STUDY, p. 39]**

- Believed fair value information would focus asset allocation strategies on shorter term investments [Also included in 4] **[KPMG BANK STUDY, p. 39]**

Also consistent with the survey results, analysts desired to obtain more and better disclosure information on loan concentrations, problem assets, and allowance for loan losses. **[KPMG BANK STUDY, p. 39]**

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), 1(c), and 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), 1(c), 10(b), and 10(d)] **[S&P, p. 16]**

The basis for competition determines which factors are analyzed for a given company. [Also included in 1(b), 1(c), 10(b), and 10(d)] **[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), 1(c), 10(b), and 10(d)] **[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), 1(c), 10(b), and 10(d)] **[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), 1(c), 10(b), and 10(d)] **[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(b) and 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[S&P, p. 19]**

[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), 3(a), and 15] **[GOLDMAN, p. 2]**

[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 1(b)] **[GOLDMAN, p. 3]**

[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 1(b)] **[BETRIOU, p. 1]**

13.43

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?

BASE: TOTAL 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
	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

BASE: TOTAL 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
	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]

13.44

Table 2.5 (continued)

KINDS OF QUALITATIVE FINANCIAL INFORMATION THAT ARE OF PIVOTAL IMPORTANCE

BASE: TOTAL 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
	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	–
Quality of assets	9	–	6	12	–	12	39	3	–	–	8	9	–	–
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	–
Economic environment	3	4	2	–	–	–	5	3	–	11	–	–	9	–
Debt ratios	2	4	2	–	–	–	–	3	–	11	–	4	–	–
Future earnings prospects	5	8	4	6	8	8	5	–	–	–	–	–	3	–
Contingency liabilities	4	6	2	–	15	4	5	6	18	–	–	–	–	–
Employment practices	5	–	2	–	–	4	–	–	–	–	–	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	–	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]

14. Other Comprehensive Basis of Accounting (OCBOA)

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	□

14. Other Comprehensive Basis of Accounting (OCBOA)

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 2(c)] **[FASOversight, p. 1]**

Financial accounting standards should be set by a body that is independent in fact and in appearance. Only a private-sector entity can so be independent. To ensure consistency, comparability and understandability, and to prevent the establishment of dual or parallel standards, the APC [Accounting Policy Committee] believes that financial accounting concepts and standards for all economic entities, both public and private, should be promulgated by a <u>single</u> standard-setting body. [Footnote reference omitted] **[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 2(c)] **[RMA90, p. 2-3]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of OCBOA statements.

Committee/Staff/Observer
Question 8 deals with the fact that accounting doesn't always get reported in a generally accepted accounting principles format, that at times reporting may adopt a different format, tax basis or cash basis, for example. Frequently it is a less stringent format than necessarily

GAAP would be. The question is: is there a role to be played for having financial statements stated on a basis other than what is deemed to be generally accepted accounting principles and if so, under what circumstances do you accept that? **[TC 3/11, p. 36]**

Participant C-2
Unfortunately, in a small bank dealing in a small business environment, you do end up accepting tax returns or cash basis statements from time to time. But I would not advocate that. I really feel like for us as a credit granting body, one set of standards should be the prescribed procedure because otherwise, comparability becomes very much impaired and you just end up as a lender not knowing exactly what you're looking at in some of these instances, not knowing exactly how to process the information when it gets very far away from the GAAP measurement and recognition rules that we think we know and understand. So we do end up accepting them but not gladly and for competitive reasons. **[TC 3/11, p. 36]**

Participant C-17
A lot of times you wind up, for cash basis statements, saying okay, now I want to see a list of your receivables. **[TC 3/11, p. 36]**

Participant C-2
That's right. You supplement it with a lot of additional information at some cost to the institution to gather and you certainly do need additional information. **[TC 3/11, p. 36]**

Participant C-13
This applies mostly to small companies, but the other instance that comes to mind is where for regulatory purposes institutions prepare statements on other than generally accepted accounting principles. Obviously, insurance companies are the primary example here. You need to be able to assess what the regulatory cap and other aspects of the company are. **[TC 3/11, p. 37]**

Committee/Staff/Observer
You get the regulatory statements as supplemental to the GAAP statements? **[TC 3/11, p. 37]**

Participant C-13
No, sometimes the companies will provide them voluntarily but you can go to the State commission and get them. **[TC 3/11, p. 37]**

Committee/Staff/Observer
You can also get the GAAP statements? **[TC 3/11, p. 37]**

Participant C-13
Yes, except in the case of some mutual organization. **[TC 3/11, p. 37]**

Committee/Staff/Observer
If you lend to a foreign company or evaluate a foreign company, will you feel the need for reconciliation to U.S. GAAP? [Also included in 18(a)] **[TC 3/11, p. 37]**

Participant C-13
That comes later but the answer is yes. [Also included in 18(a)] **[TC 3/11, p. 37]**

Participant C-17
One of the real values of regulatory statements is that you're sure they're in compliance to whatever the regulators want. It really doesn't matter how great they look on a GAAP basis if they were not in compliance to the regulators, they're not in business. Or their business is going to be severely impacted. **[TC 3/11, p. 37-38]**

Participant C-11
Regulatory statements can be very dangerous to use. Insurance companies that have had multistate operations, some of them quite famous, have gone broke because they were able to move things from one place to another. I also have used Call Reports with a great deal of caution because again, in this case not just a multistate but a multibank company, the individual Call Report can be an empty element. In other words, it's not the complete story. So GAAP is consolidation and GAAP is important. **[TC 3/11, p. 38]**

Participant C-5
On the issue of foreign corporates, we do a significant business with U.S. domiciled subsidiaries of foreign corporates and they prepare consolidated reporting in their home country, and we have typically accepted, for competitive reasons, management information using our own internal audit of that management information. We're using management-prepared information and doing our own audit standards against that. Also, we will accept tax returns. We weight them differently than we would a GAAP prepared statement but on the small end they are a workable document. Cash flow is a big component of it and a tax statement in many cases gives me more on cash flow than some of the GAAP reported statements do at the lower end. [Also included in 18(a)] **[TC 3/11, p. 38]**

Committee/Staff/Observer
Those of you who have cited competition as a problem in going from audits to something less than audits, reviews or compilations, has competition also been an issue in accepting other than GAAP statements? **[TC 3/11, p. 38]**

Participant C-7
Yes, particularly on the smaller end of our customer base; the reporting requirements basically are income tax driven. The bright side of tax returns at that level is you know it has a conservative bias. That's some comfort on income. **[TC 3/11, p. 38]**

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 9

At the meeting, participants indicated that they preferred financial statements prepared on the basis of generally accepted accounting principles (GAAP), but sometimes would accept financial statements on an other comprehensive basis of accounting (OCBOA), or tax returns *in lieu of* financial statements.

a. Under what circumstances would you accept OCBOA statements or tax returns *rather than* insisting on GAAP financial statements?

__4__ 1. Under no circumstances

__4__ 2. When I am otherwise comfortable with my lending decision, and the company does not want to prepare GAAP statements

__6__ 3. Only for small companies or small loans in which my risk of loss is limited

__1__ 4. Whenever the company refuses to prepare GAAP statements, and I will lose the loan or investment opportunity if I insist on GAAP statements.

Participant C-5: Sometimes

__2__ 5. When making credit decisions pertaining to companies operating in specific industries. If so, please identify the industries:

Participant C-13: Insurance companies, banks and bank holding companies.

Participant C-17: Insurance

__5__ 6. When making ongoing assessments of credit quality for periods for which GAAP statements are not available.

Participant C-21: Quarters?

__2__ 7. To obtain more information than is contained in GAAP statements. If so, what kinds of information do you obtain that is not part of GAAP statements:
__0__ 8. Under any circumstances
__2__ 9. Something else. Please describe:

Participant C-8: When the company is able and willing to provide additional financial data necessary to make a conversion to GAAP.

Participant C-11: Remember - I am not a lender to small companies.

Participant C-4: Will use in addition to GAAP F/S, but not in lieu of.

Participant C-6: Many privately held companies who are not frequent users of credit do not have GAAP statements prepared. Somewhat related to #3 above.

b. If you currently accept or use OCBOA statements for any of the purposes listed in a. above, please indicate below *all* the type(s) of OCBOA statements that you accept.

__4__ 1. Tax-basis statements

_8_ 2. Call reports or other regulatory reports

Participant C-12: As a supplement to holding company GAAP reports.

_2_ 3. Cash basis statements

_3_ 4. Something else. Please describe:

Participant C-8: Contractor financial statements not prepared using percentage of completion.

Participant C-13: Unreconciled statements prepared under non-U.S. GAAP, when inevitable.

Participant C-9: (A) Quarterly Reports. (B) Statistical Summaries (e.g., issued by finance companies). 2 and 4(B) as additional information not in lieu of GAAP.

c. When you DO accept non-GAAP statements or tax returns in lieu of GAAP financial statements, indicate the *frequency* of the following related circumstances:

A - Always
F - Frequently
O - Occasionally
S - Seldom
N - Never

O-3,S-1,N-2
___ 1. Additional audit work is requested.

A-1,O-2,S-1,N-2
___ 2. The interest rate required for borrowing is increased to compensate for the increased information risk.

O-4,N-2
___ 3. Amount of available lending is decreased.

Participant C-21: Bank lends based on borrowing needs - would not because we don't have GAAP F/S - we simply would not lend to company if they were of sufficient size that would dictate GAAP F/S necessary.

F-1,N-1
___ 4. Some other action is taken to respond to the use of OCBOA statements.
Please describe:

Participant C-8: Generally, additional scheduling of financial data is required.

Participant C-14: Very rare for us - only when rating commercial finance pools of small credits.

Participant C-21: Again, size of loan and company contribute to decision as to whether GAAP F/S are necessary. Obviously - they would be terrific for all lending situations but not practical.

Participant C-17: Primarily for small firms (cash basis and tax) with supporting schedules or information to estimate the extent of unbilled receivables and unpaid liabilities which are accruing but not done.
[PMQC 3/11, p. 12-15]

15. Priority of Improvements Needed in 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	□

Database of Materials on Users' Needs for Information

15. Priority of Improvements Needed in External Reporting

Investors have made numerous suggestions for improving annual reports, as shown in [the] table [below]. The suggestions address not only the information needs of investors, but also the needs for increased efficiency, improved credibility, and, for individuals only, better readability. **[SRI, p. 65]**

Suggestions for Improving Annual Reports

Suggestion	*Professional Investors* Agree	*Professional Investors* Disagree	*Individual Investors* Agree	*Individual Investors* Disagree
Be frank about reporting poor company performance	88.1%	3.8%	84.9%	2.5%
Provide information on the company's position in the marketplace (e.g., market shares)	84.0	3.5	**	**
Clearly define management plans for the future	**	**	82.6	4.3
Provide standard financial statements for each business segment	81.7	7.4	**	**
Provide comparisons with industry averages	81.1	8.0	**	**
Provide industry trend information	75.6	7.1	**	**
include the Form 10K	75.6	10.9	**	**
Define management goals and objectives	75.0	5.8	**	**
Show key financial ratios (e.g., debt to equity, return on sales, and profit margin)	**	**	74.4	11.2
Include company performance statistics and ratios	73.7	5.1	**	**
Summarize key facts and statistics to be found in the annual report in a brief abstract	54.8	19.6	68.6	11.0
Provide information on the performance of the company's stock	26.9	33.0	67.2	15.0
Provide financial projections or forecasts for the company	54.5	21.2	61.5	15.2
Use understandable language without technical jargon	32.7	37.8	60.9	16.8
Be shorter; use less redundancy	**	**	53.8	19.3

Be less promotional	**	**	44.8	21.7
Publish all annuals in a standard format	40.7	36.2	**	**
Present more information in graphs	37.5	22.8	38.6	27.6
Provide a detailed table of contents	33.3	37.8	**	**
Produce report on video cassettes	12.8	70.2	8.9	80.8

**Not suggested.
Source: SRI International survey, 1986. **[SRI, p. 66]**

The need for efficiency is the need for investors to be able to rapidly and correctly absorb the information relevant to investment decision making. To individuals, many of whom have difficulty interpreting financial information and relating it appropriately to their own investment objectives, efficiency also involves making the available information more understandable and emphasizing the more important elements. For professionals, efficiency involves providing information they would obtain from other sources and including information with a high analytical content (e.g., ratios, comparisons with norms, graphs). For increased efficiency, professionals would like annual reports to: **[SRI, p. 65]**

- Provide more company performance statistics and ratios
- Summarize key facts and statistics
- Provide financial projections and forecasts
- Be published in standardized format
- Include the SEC Form 10K
- Have more graphs
- Have a detailed table of contents
- Include stock performance information (over the longer term)
- Keep technical jargon to a minimum **[SRI, p. 67]**

Individual investors have less need to improve their efficiency than the professionals do, but still want annual reports to: **[SRI, p. 67]**

- Provide key financial ratios and statistics
- Summarize key facts and statistics
- Be shorter and less redundant **[SRI, p. 67]**

The suggestions made by individuals to improve the information content of annual reports correlate poorly with their previously expressed information needs, in part because they, unlike the professionals, do not view the annual report as an important information source for decision making, and in part because they do not view it as a vehicle for such information types as the industry outlook, economic information, and the company's own reputation. In brief, individuals would like the annual reports to: **[SRI, p. 67]**

- Define management plans for the future
- Include more key financial ratios (with some interpretation)

- Provide information on the company's stock performance
- Include financial projections and forecasts **[SRI, p. 67]**

Professionals, who do view the annual as important for investment decisions, and whose information needs are more varied and more precise than those of individuals, suggest that annuals could improve their information content if they: **[SRI, p. 67-68]**

- Show the company's position in the marketplace with market share information and other indications of competitive standing
- Provide standard financial statements for each of the company's business segments
- Compare the company's financial performance with industry averages
- Provide industry trends and other relevant information on the company's industry
- Present, in as much detail as possible, management's goals and objectives for the company **[SRI, p. 68]**

The professionals acknowledge that much of the information they would like presented in annual reports is competitively sensitive or proprietary. They feel strongly, however, that companies can disclose much more vital information than they do at present without compromising their companies' competitive positions or their management responsibilities. **[SRI, p. 68]**

The most frequent suggestion made by both individuals and professionals for improving annual reports is for managers to be frank and open about reporting their company's problems and poor performance. Not only do both groups need such information for investment decisions, but they feel strongly that management *owes* its current and potential shareholders a candid disclosure of information bearing on the value of their investments. [Also included in 2(b) and 2(d)] **[SRI, p. 68]**

In addition to more frankness and openness, individuals would like annual reports to be less promotional (less like advertising), and professionals would like the SEC Form 10K included in the annual (the 10K is closely regulated and therefore highly credible to them). **[SRI, p. 68]**

The individual investors' suggestions were also aimed at improving the readability of annual reports. They would like annual reports to: **[SRI, p. 68]**

- Include brief abstracts summarizing important facts and statistics
- Use more understandable language and less technical jargon
- Present more information in the form of graphs **[SRI, p. 68-69]**

Videotape, audio tape, personal computer diskettes, and on-line access to a service organization are not attractive options for most individual investors. Videotape and audio tape are seen as too inflexible and somehow not appropriate for investment information, and even less so for the annual report. The other two options require computer literacy and access to appropriate equipment--capabilities that are not yet typical among the individual investors interviewed. [Also included in 16(a) & 16(b)] **[SRI, p. 69]**

Professional investors express a different level of interest and are more computer literate. When asked, "Would receiving company information in any of the following ways be useful to you?" their responses were as follows: [Also included in 16(a) & (b)] **[SRI, p. 69]**

	Yes	*No*
On videotape?	34.9%	64.7%
On audio tape?	31.4	68.6
On diskettes for your personal computer?	60.9	38.8
From on-line access to a service organization	67.6	32.1

[Also included in 16(a) & (b)] **[SRI, p. 69]**

Videotape is seen by all professionals except retail stockbrokers as inflexible, and not at all useful for investment analysis; audio tapes are thought to be even less useful. Retail brokers see the possibility of using videotapes in the sales process. [Also included in 16(a) & 16(b)] **[SRI, p. 69]**

Diskettes for personal computers have initial appeal, but concern about their usability prevails. To ensure compatibility with various computers, the diskette would have to be created in one or a very few standardized formats. In addition, most professionals, especially the analysts, have developed individualized approaches to security analysis. These problems are more perceived than real, however. As these technologies become better understood and more widely available, the personal computer will become an increasingly important element in financial information distribution. [Also included in 16(a) & 16(b)] **[SRI, p. 69]**

On-line information is appealing to all segments of professional investors. Most analysts, surprisingly, are not aware of the SEC's experiment with EDGAR (Electronic Data Gathering and Retrieval). As EDGAR is just such an on-line service, professionals are likely to receive it with enthusiasm. [Also included in 16(a) & 16(b)] **[SRI, p. 69-70]**

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 5(d)] **[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 5(d)] **[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 5(d)] **[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 5(d)] **[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 5(d)] **[SRI, p. 70]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of priority of improvements needed in external reporting.

Committee/Staff/Observer
Question 16 deals with the relative priority of areas to improve external reporting. We have discussed through these four meetings important issues. On page 20 and 21 of the meeting materials, we've listed 18 items. Our question is: which three areas of external reporting, other than disaggregated information which we know is the first priority, should standard setters work on to most improve external reporting? **[TI 3/17, p. 66]**

Participant I-12
Interim reporting is very important. **[TI 3/17, p. 66]**

Participant I-11
Interim reporting, accounting for financial instruments, and unconsolidated entities and there I favor the expanded equity method. [Also included in 6] **[TI 3/17, p. 66]**

Participant I-5
Consolidation practices and unconsolidated entities are in the top three. **[TI 3/17, p. 66]**

Participant I-11
Number 2 (consolidation practices) and 3 (unconsolidated entities) are closely linked. **[TI 3/17, p. 66]**

Participant I-16
I would agree with numbers 3 (unconsolidated entities) and 12 (interim reporting). I would add numbers 5 (business combination practices), 8 (disclosure of measurement uncertainties), and 16 (impairment); for number 16, I'm more concerned about long-lived assets than receivables. For number 8, I'm concerned with getting more explanations about where things are and come from. Business combination practices is an area where we don't understand how companies account for acquisitions; they don't explain that and you can't follow it. [Also included in 8(b) and 9] **[TI 3/17, p. 66]**

Participant I-7
Numbers 5 (business combination), 8 (measurement uncertainties), and 10 (disclosure of operating opportunities and risks). **[TI 3/17, p. 66]**

Participant I-12
Numbers 13 (financial instruments) and 8 (measurement uncertainties), and 10 (operating opportunities and risks). **[TI 3/17, p. 67]**

Participant I-5
I would add 7 (fair values), 8 (measurement uncertainties), and 11 (core earnings). **[TI 3/17, p. 67]**

[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, creditors were asked about their priorities for improvements in external reporting.

Committee/Staff/Observer
We understand from investors and equity analysts that improvements in disclosure of disaggregated information might be needed. The question we have is: is that the highest priority? **[TC 12/8, p. 26]**

Participant C-1
Yes, most definitely. Disaggregated information is very important to us. **[TC 12/8, p. 26]**

Committee/Staff/Observer
[Participant C-1] is it more important than straightening out what I'll call core earnings to get the unusual items out of it, or separated from it? **[TC 12/8, p. 26]**

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 5(a)] **[TC 12/8, p. 26]**

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 3(d) and 11(c)] **[TC 12/8, p. 26-27]**

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 5(d)] **[TC 12/8, p. 27]**

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 5(c)] **[TC 12/8, p. 27]**

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 5(b)] **[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 5(a)] **[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 5(a)] **[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 3(b)] **[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 5(a)] **[TC 12/8, p. 28-29]**

Participant C-9
Another issue I would be interested in getting more information to work with is the off balance sheet information regarding swaps, derivatives, futures, etc. I think [name deleted] has set a standard of disclosure for others to strive toward, but I think there is a lot more that could be reported, and we're talking very significant dollar flows. I mean you look at [names deleted], we're talking trillions of dollars that aren't even on the balance sheet, and you have very little information. [Also included in 19] **[TC 12/8, p. 29]**

[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.

Committee/Staff/Observer
Question 17 is the last question. I'd like if I could to get you to tell me those two or three things that you think ought to be given the greatest amount of attention in terms of what could improve financial reporting. Auditors, financial statements, the ball park is as wide and as broad as you want to define it and it certainly isn't restricted to the list in the meeting materials. I would also ask that you give me an understanding of whether or not it's the rules of the game that need to be changed, that is, there is something that we are doing that is correct according to what the rules are that needs to be changed, or whether or not it's the way people do things, that is, the practical application of the rules. **[TC 3/11, p. 68]**

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 5(a)] **[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 5(a) and 19] **[TC 3/11, p. 69]**

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 3(d), 11(c), and 19] **[TC 3/11, p. 69]**

Committee/Staff/Observer
You chose number 12, interim reporting because of the disaggregated information aspect? **[TC 3/11, p. 69]**

Participant C-13
Yes. I would also choose number 3 (unconsolidated entities). **[TC 3/11, p. 69]**

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 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), 5(c), and 19] **[TC 3/11, p. 69-70]**

Participant C-15
I'll go with number 11 (core earnings) as my first choice. And 13 (financial instruments) is my second choice. [W]e always ask the questions and we meet with financial institutions and increasingly with industrial companies and so on about their off-balance-sheet financing, in particular swaps and other types of instruments. And I think that we find at the senior

management level, CFO level, that we deal with that they broadly understand the issues. But when it comes down to getting into specifics, they say that they have somebody locked away in a corner room someplace who is really doing all this work. Something going forward which I think is going to be increasingly important are these environmental liabilities (number 14). They're kind of difficult to get your hands around but these are the types of things, if you look at a company like [name deleted] for example, that just came out of the clear blue. You looked at their balance sheet and income statement, you didn't have a hint anything was wrong with the company. Well, you knew something was wrong by reading the footnotes that they had these asbestos related liabilities but the next thing they're on their way over to bankruptcy court. I think that disclosure of those types of liabilities going forward is going to be increasingly important. [Also included in 10(b) and 19] **[TC 3/11, p. 70-71]**

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 4, 8(b), and 19] **[TC 3/11, p. 71-72]**

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 5(a) and 13] **[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(a) and 5(d)] **[TC 3/11, p. 72]**

Participant C-8
I think in short just improve disclosure, probably as it relates to 3, 11 and 13. My feeling principally with private companies we have access to getting most of this information and, in fact, do get it but we don't have the ability or the insurance that you would provide in disclosing more of this information in the annual reports. **[TC 3/11, p. 73]**

Participant C-11
11 (core earnings), 3 (unconsolidated entities) as it encompasses also annual and interim segment reporting by business, major business segments. And also 13 (financial instruments) but only if you really can get something related to the risk aspects of those matters as opposed to just lots more numbers. And I don't know if that's possible so I really want to put it with that caveat, that more information that is not analytically useful in terms of understanding risk is not helpful. [Also included in 19] **[TC 3/11, p. 73]**

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 5(d)] **[TC 3/11, p. 73]**

Participant C-17
I'm not going to expound on what's already been said about the categories, just add whatever addition or comment that seems appropriate. Number 11, core earnings, is my first choice. And I really felt that number 9 (display) was almost an integral part of that. And then from there, I looked at number 13 (financial instruments) as second in order because I am not convinced that even senior management of the company really truly understands what it's all about. So it's sort of a backdoor way of getting their attention. There are too many instances where they've had surprises that they were totally unaware of because they didn't completely understand. And then 10 (operating opportunities and risks) for the obvious reasons. [Also included in 19] **[TC 3/11, p. 73-74]**

Committee/Staff/Observer
I have proxies for both [participant C-2] and [participant C-7]. [Participant C-2] would opt for 9 (display) first, 11 (core earnings) second. She had four that were tied for third, 4 (reducing

accounting choices), 6 (goodwill), 8 (measurement uncertainties), and 18 (auditing). She didn't explain what aspect of 18. She points out though that if 9 is done correctly, the importance of 11 isn't as significant. And then [participant C-7] votes are 11 (core earnings), 10 (operating opportunities and risks) and 9 (display) in that order. **[TC 3/11, p. 74]**

Committee/Staff/Observer
I have a specific question on 13 which is accounting for financial instruments including off balance-sheet-financing. Those who ranked that in the top three, did you include off-balance-sheet leases or weren't you thinking about it? [Also included in 8(c) and 19] **[TC 3/11, p. 74]**

Participant C-11
Not in the same context. For different reasons, I think this classifies as off-balance-sheet. I think they're very different risks. [Also included in 8(c) and 19] **[TC 3/11, p. 74]**

Committee/Staff/Observer
So would you also encompass in 13 changes in accounting or information about off-balance-sheet leases? [Also included in 8(c) and 19] **[TC 3/11, p. 75]**

Participant C-11
I think it should be on balance sheet myself but . . . [Also included in 8(c) and 19] **[TC 3/11, p. 75]**

Committee/Staff/Observer
But the reason is not because of the qualitative questions you had with respect to everything else that's off-balance-sheet? [Also included in 8(c) and 19] **[TC 3/11, p. 75]**

Participant C-17
I don't think anybody's mystified about what an operating lease is all about. I think there's a great deal more esoteric around the hedging situation. I'm not certain that the management itself always has the sophistication or focus that they ought to. [Also included in 8(c) and 19] **[TC 3/11, p. 75]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 27

At the meeting, each group participant was asked to identify the three most important accounting and reporting issues that should be addressed urgently by standard setters. You are asked to answer that same question again, but please note that you are not bound by the answers you gave at the meeting. You have had the opportunity to hear others' views as well as reconsider your own. This is your opportunity to change or reaffirm your initial response.

REMEMBER: We have *already* recorded the user need for disaggregation as an urgent need. You do not have to include it in your rankings.

Please rank from 1 to 3 (1 is highest) the three of the eighteen general categories listed on the next page that you believe are most important and in need of urgent attention by standard setters. For each of the 3 general categories that you identified, please indicate whether the change needed is:

R A change in the rules or standards that pertain to the issue (that is, you believe the rules or standards are inadequate)

A A change in the practical application of the existing rules or standards that pertain to the issue (that is, you believe the way companies or auditors apply the rules or standards in practice is inadequate, not the rules or standards themselves)

Also, for each general category identified, please circle the subcategories that caused you to select the general category.

Please do not consider yourself limited to the topical list below.

List of topics	*Priority of general category (select 3)*[1]	*Change needed*[2]	
		Rules	*Application*
1. Disclosure of Nonbusiness Information such as: • Statistics on the economy or industry • The company's mission and intent, its strategy, its competitive advantages and disadvantages, the description of its segments, etc.	*Participant I-7 -3*	*1*	
2. Consolidation Practices, such as what entities should be consolidated • *Participant I-11:* Finance subs of non-finance companies. I don't think you can separate 2 and 3.	*Participant I-11 -2*	*1*	
3. Unconsolidated Entities: • Proportionate consolidation versus equity method versus expanded equity method • Scope and content of additional disclosures about unconsolidated entities	*Participant I-11 -2*	*1*	

[1] For each general category selected, please circle the subcategories that caused you to select the general category.
[2] Please write **A** or **R** for the three general categories that you selected.

List of topics	*Priority of general category (select 3)*[3]	*Change needed*[4]	
		Rules	*Application*
4. Reducing Accounting Choices for: • Inventory valuations • Depreciation • Leasing	*Participant I-16 -1*	*1*	
5. Business Combination Practices: • Purchase method versus pooling of interests • Extent of disclosures to be made about the acquisition (fair values, provisions set up on acquisition, etc.) [*Participant I-16]* • *Participant I-16:* Inadequate disclosure of reserves, asset writedowns, tax considerations	*Participant I-16 -2, Participant I-11 -3*	*2*	*2*
6. Accounting for Goodwill and Other Intangible Assets			
7. Use of Fair or Market Values in Financial Reports: • Recording assets and liabilities at fair value in financial statements • Disclosing fair or market value information in the notes to financial statements			
8. Disclosure of Measurement Uncertainties			
9. Display of Financial Information: • To better identify nonrecurring items • To provide more insight into the operations of the company's business	*Participant I-7 -1, Participant I-11 -1*	*2*	*1*
10. Disclosure of Operating Opportunities and Risks	*Participant I-7 -2*	*1*	

[3] For each general category selected, please circle the subcategories that caused you to select the general category.
[4] Please write **A** or **R** for the three general categories that you selected.

List of topics	*Priority of general category (select 3)*[5]	*Change needed*[6]	
		Rules	*Application*
11. Developing a Concept of Core Earnings for the Income Statement addressing (among other issues): • Nonrecurring versus unusual versus extraordinary items • Depreciation and other noncash charges • Amortization of goodwill and other intangible assets • *Participant I-16:* Companies boost earnings by understating expenses and then taking "non-recurring" adjustments to asset values	*Participant I-16 -3, Participant I-7 -3, Participant I-10 -3*	*2*	*1*
12. Interim Reporting: • Frequency and scope of reporting • Integral versus discrete view			
13. Accounting for Financial Instruments, including: • Off-Balance-Sheet Financing • Hedging and Hedge Accounting	*Participant I-10 -2*		*1*
14. Environmental Liabilities			
15. Stock Compensation			
16. Impairment of Receivables (including loan receivables) and Impairment of Long-Lived Assets			
17. Conservatism versus Neutrality			
18. Auditing, including: • Improving the quality of audits as currently defined • Expanding the scope of the material audited • Expanding the scope of the audit report	*Participant I-10 -1*	*1*	
[1] Please write A or R for the three general categories that you selected.			
[2] For each general category selected, please circle the subcategories that caused you to select the general category.			

[PMQI 3/17, p. 45-48]

[5] For each general category selected, please circle the subcategories that caused you to select the general category.
[6] Please write A or R for the three general categories that you selected.

[One analyst] expressed the following . . . regarding his approach to securities analysis: [Also included in 1(a), 1(b), and 2(c)] **[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 2(c)] **[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 1(b)] **[BEAR STEARNS, p. 2]**

To improve financial reporting, from an analyst's point of view, [one analyst] recommended . . . the following. . . : [Also included in 1(b), 2(c), 3(a), 8(d), 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 3(a)] **[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 2(c) and 8(d)] **[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(a), 1(b), 5(c), and 6] **[BEAR STEARNS, p. 3]**

- It would be helpful if nonhomogeneous (e.g., finance) subsidiaries were disaggregated from the consolidated financial statements. [Also included in 1(b) and 6] **[BEAR STEARNS, p. 3]**

[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:

Costs:
While most precious metals companies provide operating costs per unit, each company defines these differently. The subcommittee would like to see the industry take the initiative on developing some uniform reporting standard. **[AIMR/CIC91, p. 1]**

Reserves:
While reserves are provided by all companies, like costs they are derived differently. The subcommittee would like more consistent definitions of reserves and assumptions behind these reserves. (Ditto for the oil industry.) **[AIMR/CIC91, p. 1]**

[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 5(a)] **[AIMR/CIC91, p. 1]**

The most often repeated shortcomings or suggestions in a broad range of [CIC] subcommittee reports might be summarized as follows:

- Better segmented reporting, particularly in quarterly reports. [Also included in 3(a)]
- Change is occurring so rapidly that well informed, readily available investor contact is crucial. [Also included in 16]
- Strategic input from top management, communicated in annual reports, meetings, and or by other means. [Also included in 16]
- Consistent operating data should be available that can, in some way, be related to reported financial data. [Also included in 2(c)]

[AIMR/CIC91, p. 2]

[The CIC] Retail [S]ubcommittee. . . suggested [the following] improvements:

- More release of monthly sales data.
- Break-out of results for the seasonally important fourth quarter. [Also included in 11(a)]
- Annual and quarterly release of divisional operating results. [Also included in 11(a)]
- Greater disclosure of historical health benefit liabilities.

[AIMR/CIC91, p. 2]

[The CIC has commented that] while the annual report remains the primary corporate communication and the quarterly report ranks very high, there is increasing emphasis on "extra efforts" put forth by management. The "factbook" with up to ten-year financial records continues as the most respected extra. Timely and meaningful press releases covering important developments are often cited. Quarterly conference calls and analyst meetings are also becoming more important and may well reflect growing investor concern for short-term "market performance." Many investors cite the absence of a separate fourth quarter report as a continuing sore point. Fax machines are a wonderful tool for the rapid dissemination of hard copy data but this newer means of distribution is often overworked. We stress again that corporate communications should not be confined to the professional investment community but also directed to the general investing public. [Also included in 11(b) and 16(b)] **[AIMR/CIC92, p. 2]**

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 2(a), 11(a), and 16(b)] **[AIMR/CIC92, p. 3]**

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 4] **[KPMG BANK STUDY, p. A-3]**

- **If you could obtain additional information about a financial institution, select the letter which best describes your preference for expanded disclosure:**
  a. Strongly favor
  b. Favor
  c. Do not favor
  d. No opinion

15. **Priority of Improvements Needed in External Reporting--Page 19**

A	B	C	D	
45%	33%	20%	2	Anticipated amount and timing of future cash flows from non-performing assets
10	55	28	7	Loan maturity characteristics incorporating estimate prepayment assumptions
43	43	13	1	Original loan terms and renegotiated terms for restructured assets
83	17			Prior loan charge-offs relating to existing problems assets
55	38	3	4	Cash flow experience relating to problem assets
70	18	10	2	Internal loan classification/risk ratings
65	28	7		Material comments contained in regulatory reports
18	40	33	9	Amount and timing of future cash flows from off-balance-sheet financial instruments
3			97	Other

[KPMG BANK STUDY, p. A-6]

- **If you could obtain only one additional piece of information about a financial institution, what would it be?**

Cash flow experience relating to problem assets.

Loan collectibility.

Material comments contained in regulatory reports.

Expected maximum loss content in identified non-performing assets. This provides one with a measure of the "worst case" scenario and the ability of a bank to cope with that scenario.

Internal loan classification.

More detailed information regarding long-term credit record for assets by original actual risk classification.

Breakout of retail loans and deposits by type.

Internal risk classification of performing loans.

Variance analysis comparing results to management expectations.

Relevant data from examination reports (not including specific credits).

Since your question does not specify "financial" information, I would like to know the hiring priorities (senior level). This information for the future tells me more about the company than any historical information could possible convey!

More detailed information about loan characteristics.

Criticized and classified loans - it would provide great insight into likely trends of nonperforming assets.

Prior loan charge-offs of problem and criticized assets. Lack of disclosure of these amounts renders any attempt to measure reserve adequacy useless.

Breakdown of funding against assets (on and off-balance-sheet) i.e. mismatch or match funding positions.

All relevant data on any significant non-performing assets.

A look at loan risk-ratings outside the non-performing category.

Latest bank examination report or at least the resulting CAMEL rating and components.

Further information on non-performing assets with historical analysis.

Dollar amount of loans classified substandard and doubtful.

Current status of collateralization of non-performing assets (not just loans).

Internal loan classifications.

Line of business reporting for companies operating in several sectors (business or geographic depending on the company).

Internal loan classifications and risk ratings which are most important to estimating changes in risk/reward ratio of a bank stock.

Sources and uses detailed to estimate [recurring] operating cash flow.

A detailed breakdown of loan classification over time.

A better breakdown of the loan portfolio and non-performing loans in each category.

Mark-to-market estimated value.

Loans-more information about the composition of the portfolio, especially with respect to quality.

Real allocation of loss reserves by loan category and to problem assets.

Internal loan classifications/risk ratings.
[KPMG BANK STUDY, p. A-6 and A-7]

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), 4, 10(b), and 11(a)] **[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 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-9]**

[One user commented] no. Market values are too judgmental, I prefer historical cost plus disclosure. [Also included in 4] **[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 4] **[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 4] **[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.

[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 4] **[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 4] **[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 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. [Fair value estimates] should be handled in notes. [Also included in 4] **[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 4] **[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), 2(c), and 4] **[KPMG BANK STUDY, p. A-10]**
2) *In loan valuation, changes due to changed assessment of credit risk would be indistinguishable from changes due to interest rate movements.* [Also included in 4] **[KPMG BANK STUDY, p. A-10]**
3) *Increase potential for accounting abuses.* [Also included in 2(b) and 4] **[KPMG BANK STUDY, p. A-10]**
4) *Certain intangible franchise values would be ignored.* [Also included in 4] **[KPMG BANK STUDY, p. A-10]**

[One user commented] no. You need both to gain a proper perspective. [Also included in 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-10]**

[One user commented] too judgmental once one gets away from liquid and marketable instruments. [Also included in 2(b) and 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-11]**

[One user commented] yes. But need a transition period with both historical and current provided. [Also included in 4] **[KPMG BANK STUDY, p. A-11]**

- **For each of the categories list 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 4] **[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 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-11]**

[One user commented] no. I would like increased footnote disclosure of fair market calculations. [Also included in 4] **[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 4] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Information is subject to too much management judgment. [Also included in 4] **[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 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY,
p. A-12]**

[One user commented] no. Historical cost should be maintained but disclosure should be broadened. [Also included in 4] **[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 4] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Should not be done piecemeal. [Also included in 4] **[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 4] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. The footnote of market values works fine. [Also included in 4] **[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 4] **[KPMG BANK STUDY, p. A-12]**

[One user commented] no. Both give you a more comprehensive picture. [Also included in 4] **[KPMG BANK STUDY, p. A-12]**

[One user commented] yes. Provided that liabilities funding investments are similarly adjusted. [Also included in 4] **[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 4] **[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), 4 and 10(b)] **[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 4] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no. Not appropriate, but 12-18 moths is too short. [Also included in 4] **[KPMG BANK STUDY, p. A-13]**

[One user commented] depends, fair value footnotes would be helpful. [Also included in 4] **[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 4] **[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 4] **[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 4] **[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 4 and 10(b)] **[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 4] **[KPMG BANK STUDY, p. A-13]**

[One user commented] no opinion. Should not be done piecemeal. [Also included in 4] **[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 4] **[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 4] **[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 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. Intent and ability are subject to change. [Also included in 4] **[KPMG BANK STUDY, p. A-14]**

[One user commented] yes. You need both! [Also included in 4] **[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 4] **[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

[One user commented] no. Assuming adequate footnotes [provide] market values, where available, as well as asset quality. [Also included in 4] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Not unless all asset and liability categories are accurately adjusted. [Also included in 4] **[KPMG BANK STUDY, p. A-14]**

[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 4] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Only where liquidation is imminent. [Also included in 4] **[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 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-14]**

[One user commented] no. Disclose the pieces and allow investors to make their own judgements. [Also included in 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. If done for entire balance sheet. [Also included in 4] **[KPMG BANK STUDY, p. A-15]**

[One user commented] yes. Negative trends will be apparent quicker. [Also included in 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-15]**

[One user commented yes.] Only if handled correctly. [Also included in 4] **[KPMG BANK STUDY, p. A-15]**

[One user commented yes.] It will provide another view. [Also included in 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-15]**

[One user commented I would] prefer to have timely cost data. [Also included in 4] **[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 4] **[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 4] **[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 4] **[KPMG BANK STUDY, p. A-15]**

[Context] The papers are a summary of a committee and staff members' discussions with selected sell-side analysts from Goldman Sachs.

With the exception of disclosure of management's forecasts and projections, the analysts generally confirmed that [the following] list of areas for improvement is both accurate and complete. In particular, most emphasized the importance of disaggregated information. In contrast, most of the analysts were uncertain about management's forecasts and projections. Many were concerned about whether they could ever rely on those forecasts. [Some believe] that analysts [themselves] should develop their own forecasts. [The list recommends:]

1. better disaggregated information.
2. more complete quarterly reporting. That is, interim reporting that more closely resembles annual reporting.
3. better identification and explanation of extraordinary, unusual, and infrequent items.
4. better information about measurement uncertainties, and operating opportunities and risks.
5. improved comparability and consistency in financial reporting methods over two business cycles, including disclosure of ten year summary information.
6. disclosure of the company's goals and objectives

7. better clarity in external reporting without reducing the amount of information.
8. disclosure of management's forecasts and projections.

[Also included in 11(c) and 12] **[GOLDMAN, p. ii-iii]**

Every analyst emphasized the critical role in their work of external financial reporting. They also affirmed the importance of audited financial statements.
[Also included in 11(c) and 12] **[GOLDMAN, p. iii]**

[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), 3(a), and 13] **[GOLDMAN, p. 2]**

[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 5(c)] **[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 1(b) and 5(a)] **[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 1(b)] **[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), 5(c), 6, 8(a), 9, 11(b), and 11(c)] **[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 2d] **[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 2(d)] **[BETRIOU, p. 2]**

If accounting data should be complete, using it should nonetheless remain as simple as possible. [Also included in 2(d)] **[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 2d] **[BETRIOU, p. 2]**

It therefore seems more advisable to have less possibilities in presentations. [Also included in 2(d)] **[BETRIOU, p. 2]**

- 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 5(c)] **[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 1(b), 11(b), and 11(c)] **[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 1(b), 11(b), and 11(c)] **[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 1(b) and 3(c)] **[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 3(c)] **[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 1(b)] **[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 1(b)] **[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 1(b)] **[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 1(b) and 2(c)] **[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 2(c)] **[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. Alternations in the consolidation circle during the financial year are presently made "pro rata temporis". [Also included in 1(b) and 2(c)] **[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 1(b), 4, 5(a), 6, 8(a), and 9] **[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 1(b)] **[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 1(b)] **[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 1(b) and 8(a)] **[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 1(b) and 6] **[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), 4, and 9] **[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), 4, and 9] **[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), 4, and 9] **[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), 4, and 9] **[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), 4, and 9] **[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 5(a)] **[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 1(b)] **[BETRIOU, p. 3]**

[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.

[The buy-side equity analyst] believes that the biggest problem with external reporting is that companies manipulate reported earnings by:

- artificially smoothing key trends in revenues and costs to create an illusion of consistency
- reporting from time to time accumulated charges as non recurring items, often included in a "restructuring" charge, even though the charges are recurring and result from the normal operations of the business.

[FREEDMAN, p. 2]

As a result of that manipulation, [it is] believe[d] that many investors underestimate the riskiness (because of the artificial smoothing) and overestimate the company's ability to generate future cash flows (because of non recurring label assigned to certain charges). **[FREEDMAN, p. 2]**

[A]nother serious problem for investors results from the accounting convention of amortizing intangibles and goodwill. [D]uring the 1980's, many companies entered into LBO transactions, adopted a new basis of accounting, and recognized significant amounts of intangible assets and goodwill. On the other hand, other companies did not participate in LBO transactions and continued to follow their historical basis of accounting often reporting only modest amounts of intangible assets and goodwill. Because of the requirement to amortize intangibles and goodwill and the diversity in accounting measurements resulting from some companies adopting a new basis of accounting, two companies in similar economic circumstances often report very different income. [M]any sophisticated investors have not considered the differences resulting from amortization expense when comparing and valuing companies. Thus, when comparing the income of companies, the reported amount of amortization expense [often is added to income]. **[FREEDMAN, p. 2-3]**

Because of the problems discussed in [the previous two paragraphs], [the] assessment of a company's performance gives heavy weight to the following performance measure:

$$\frac{\text{Fair value of the company's debt and equity}}{\text{Cash flow from operations}}$$

[FREEDMAN, p. 3]

[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 3(a)] **[FREEDMAN, p. 3]**

[T]he general categories of information on the Nonfinancial Business Subcommittee's list of information needs [was discussed]. [E]ach of those categories [were found] to be relevant, and no additional categories [were offered] for consideration. [T]he relative usefulness of information in those categories varies widely depending on the company's circumstances such as its industry structure, the stage in its life cycle, or at the time of new developments. That is, sometimes the information is critical and other times it is not. **[FREEDMAN, p. 3]**

16. Communication and Transmittal

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	□

16(a). Databases

Videotape, audio tape, personal computer diskettes, and on-line access to a service organization are not attractive options for most individual investors. Videotape and audio tape are seen as too inflexible and somehow not appropriate for investment information, and even less so for the annual report. The other two options require computer literacy and access to appropriate equipment--capabilities that are not yet typical among the individual investors interviewed. [Also included in 15 and 16(b)] **[SRI, p. 69]**

Professional investors express a different level of interest and are more computer literate. When asked, "Would receiving company information in any of the following ways be useful to you?" their responses were as follows: [Also included in 15 and 16(b)] **[SRI, p. 69]**

	Yes	***No***
On videotape?	34.9%	64.7%
On audio tape?	31.4	68.6
On diskettes for your personal computer?	60.9	38.8
From on-line access to a service organization?	67.6	32.1

[Also included in 15 and 16(b)] **[SRI, p. 69]**

Videotape is seen by all professionals except retail stockbrokers as inflexible, and not at all useful for investment analysis; audio tapes are thought to be even less useful. Retail brokers see the possibility of using videotapes in the sales process. [Also included in 15 and 16(b)] **[SRI, p. 69]**

Diskettes for personal computers have initial appeal, but concern about their usability prevails. To ensure compatibility with various computers, the diskette would have to be created in one or a very few standardized formats. In addition, most professionals, especially the analysts, have developed individualized approaches to security analysis. These problems are more perceived than real, however. As these technologies become better understood and more widely available, the personal computer will become an increasingly important element in financial information distribution. [Also included in 15 and 16(b)] **[SRI, p. 69]**

On-line information is appealing to all segments of professional investors. Most analysts, surprisingly, are not aware of the SEC's experiment with EDGAR (Electronic Data Gathering and Retrieval). As EDGAR is just such an on-line service, professionals are likely to receive it with enthusiasm. [Also included in 15 and 16(b)] **[SRI, p. 69-70]**

Technological advances, especially in data analysis and communications, will significantly affect all corporate reporting, including the annual report. The SEC's EDGAR project, the increasing numbers of analysts using computer-aided analytical techniques, and the interest of

> professional investors in receiving annual report information in PC-compatible form and from on-line access to data services are just three examples of recent influences. **[SRI, p. 72-73]**

[Context] The AIMR position paper provides a summary of the section (pages 11-20) entitled "The Changing World and Its Implications for Analysis," which describes the effects on financial analysis and financial reporting of three major phenomena:

> The world constantly is changing and everyone must adjust to accommodate those forces over which they have no control. The nature and implications of three major phenomena that are expected to affect financial analysis and analysts are considered here. Those matters also have considerable influence on the views and conclusions expressed later in the paper. . . . [Also included in 7(b), 18(a), and 19] **[AIMR/FAPC92, p. vi]**

> Second, the accessibility of computing power continues to rise as rapidly as its cost falls, which has several implications for financial analysis. Quantitative analysis becomes practicable to an extent never dreamed of previously. There are more and ever increasing demands for and uses of databases of financial information. We look forward to the inauguration of the SEC's Electronic Data Gathering And Retrieval (EDGAR) system. All this means that financial analysis will require more emphasis than ever before on recognition and measurement in financial reports so that we may be assured that the contents of databases are both complete and comparable. **[AIMR/FAPC92, p. vii]**

[Context] Those two paragraphs introduce the following excerpts pertaining to the second major phenomenon listed. Excerpts pertaining to the other two phenomena are included primarily in 18(a)-International harmonization of standards and 7(b)-Other intangible assets, 8(b)-. . . [A]ccounting for business combinations, and 19-Financial instruments and off-balance-sheet financing, with a few excerpts included in other categories.

> <u>Quantum Increases in Computing Power and Access to It</u>
> One wonders if and when the pace of progress in computing will ever slow. Processing speeds and storage capacity continue to become available in large quantities and at low prices unheard of previously. A corollary is that computing also has been made available to individuals and become portable. Where it all will lead ultimately is not for us to guess. Our task here is to assess how it has and will change financial analysis and investment techniques as well as the implications of those effects for financial reporting. **[AIMR/FAPC92, p.14]**

> The preceding section of this report deals with globalization of the securities industry. In many respects that happening has been made possible by computing power aided by similar advances in telecommunications. As a result, money can be moved around the world quickly to take advantage of investment opportunities wherever and whenever they appear. Records

can be updated instantly. Information may be formatted for computer processing and transmitted via modem or equivalent. [Also included in 18(a)] **[AIMR/FAPC92, p.14-15]**

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 1(b)] **[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 1(b)] **[AIMR/FAPC92, p. 15]**

The implications 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 2(c)] **[AIMR/FAPC92, p. 15**

The SEC's Electronic Data Gathering And Retrieval system (EDGAR)
We look forward to the imminent arrival of the SEC's new method of making company filings available. Although it has been many years in development and subject to multiple delays, it promises to be a vast improvement over the present system. It will place documents in electronic storage and overcome the frequent problems of missing and misfiled documents now encountered by analysts or the agencies serving them. It will also dispense information faster than currently by placing a document in the database when it is received. It will not be directly accessible by analysts; instead its contents will be marketed by vendors selected by the SEC. It promises to surpass all other databases for its sheer quantity of information about

public companies. Eventually, it may make even the most recalcitrant analyst into a database user. **[AIMR/FAPC92, p. 15]**

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 2(c)] **[AIMR/FAPC92, p. 48]**

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 2(c)] **[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 2(c)] **[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 2(c)] **[AIMR/FAPC92, p. 49]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of databases.

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 1(c)] **[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 1(c)] **[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 1(c) and 2(b)] **[TI 3/17, p. 48-49]**

Committee/Staff/Observer
Do you use your own databases or do you purchase them? **[TI 3/17, p. 49]**

Participant I-16
I purchase them. **[TI 3/17, p. 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 1(c)] **[TI 3/17, p. 49]**

Committee/Staff/Observer
How do you know what's in databases is accurate or complete? [Also included in 2(b)] **[TI 3/17, p. 49]**

Participant I-7
You don't. [Also included in 2(b)] **[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 2(b)] **[TI 3/17, p. 49]**

Committee/Staff/Observer
Do you know if the databases are ever adjusted? **[TI 3/17, p. 49]**

Participant I-16
Generally not. You don't want them to be; you want the numbers as they were originally reported. People valuing stocks in 1982 didn't know that an acquisition would occur in 1987 and didn't value the stock based on that future acquisition. So if you're using valuation numbers from a past time period, you have to use the numbers that were reported by the accountants at that point in time. **[TI 3/17, p. 50]**

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 1(c) and 2(b)] **[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 1(c)] **[TI 3/17, p. 50]**

Committee/Staff/Observer
Do you find the cost of obtaining a database acceptable in relation to the benefits received? **[TI 3/17, p. 50]**

Participant I-16
They're very cheap. **[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. During the discussion, comments were made on databases.

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 significantly 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 2(c)] **[TC 12/8, p. 43-44]**

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 1(c)] **[TC 12/8, p. 62]**

[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 databases.

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 4] **[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 4 and 5(d)] **[TC 2/2, p. 11]**

Committee/Staff/Observer
Would you rather have the database? Or would you rather have what we now call financial statements that take data and bring it to one level of analysis. And the following question is: how high a level does the accountant should analyze and process the data? **[TC 2/2, p. 12]**

Participant C-5
In financial analysis, you realize there's no perfect point. There's a curve. And that's the problem. There's a trade-off: if you give me more detail for my database, I lose in the database in terms of numbers companies included in it. I don't know where my efficient frontier as far as trade off and how many things I can follow versus how detailed I can get. **[TC 2/2, p. 12]**

Participant C-2
In a database you won't have the same assurance that you get from organized financial statements and disclosures. And I think you tap into the database kind of at your own risk. **[TC 2/2, p. 12]**

[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 databases.

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 5(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 5(a)] **[TC 2/2, p. 16]**

Participant C-2
Kind of like on an on-line real time basis. [Also included in 5(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 5(a)] **[TC 2/2, p. 16]**

Participant C-5
While you may be speaking of a database for an individual company, and getting access to that, there is a world of financial analysis out there that lives in comparability of financials. And once data get embedded into a database, they're there. Five years from now, we'll never look back and figure out what was that, was it a non-recurring item? There is a part of this accounting profession which is setting standards for things like those databases out there. Once you define them, that's what's in the database. I sat just recently with a small operational area of our credit department. It's going to take a big stick of dynamite to pull apart the whole credit department to get them to have flexibility on anything that is not accounting profession endorsed and adopted because if a lending officer might modify a number, it's a real problem for me. **[TC 2/2, p. 17]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of databases.

Committee/Staff/Observer
Question 13. We've read in different documents that use of databases for analysis is becoming more and more popular but that there are limitations; I guess the extremes are you can have Compustat which puts everything in an absolute format and you can have things like the accountants use on NARS that are essentially the company's formats completely. And because of that, the comparability is very difficult because no two companies use exactly the same words. How much databases impact what you do, how much accounting either interferes with the use of databases or complements that or are there things that accounting should do to make use of databases easier? And finally we're curious about when you use databases, given that those are kind of apart from the financial statements themselves? How do you get confident that you're using numbers that are, in fact, the numbers? **[TC 3/11, p. 53]**

Participant C-5
I have probably in the last six years not looked at raw audited financial statements to read them myself. They're always spread by an analyst or a spreader and then the loan officers make their adjustments and their comments that describe the situation. So I'm already seeing something that's prefiltered and at times I'm actually more comfortable with a Compustat that is not trying to propose a credit that I have to make a decision on, and therefore has an interest in certain presentations that's biased to the decision that I'm supposed to be making. I'm different a little bit because I'm once removed from the first proposal. **[TC 3/11, p. 53]**

Committee/Staff/Observer
But for those people who are making the first cut? **[TC 3/11, p. 53]**

Participant C-5
No, they start out with raw data. **[TC 3/11, p. 54]**

Participant C-17
Databases are used as a way to increase your efficiency. You get more speed than having someone sit down and manually spread them. You use the financial statements as your source document and the only real limitation on databases has been the timeliness. It's difficult to get current numbers, you're always a quarter or so behind than what you could get if you went and made a request of the company. **[TC 3/11, p. 54]**

Participant C-11
We only use databases as a substitute for the need for a quick initial look at the numbers for which we don't have the financial statements in the file. We would never invest on the basis of any spread Compustat thing. Our analysts have to do their own ratio work and particularly in cases where there have been any kind of acquisitions or dispositions, the database is really going to be quite unreliable. **[TC 3/11, p. 54]**

Participant C-10
It seems to be a personal choice. Our equity people use databases more than what we do. To my knowledge, we don't use them at all. We tried to work with one recent high yield database company and found that there wasn't anything of value in it. **[TC 3/11, p. 54]**

Committee/Staff/Observer
Why did you find it to be "garbage"? **[TC 3/11, p. 54]**

Participant C-1
A lot of inaccurate numbers. They filtered everything; maybe it's just the nature of high yield companies, they're more in flux, but I don't think so. What we used was the in depth database that Wall Street raves about. And it would come out and their format wasn't applicable. Using their numbers it's just terrible. **[TC 3/11, p. 54]**

Participant C-15
Compustat is owned by Standard & Poor's so I'll temper my comments but we used that as the beginning point of our analysis just to get a quick feel for a company. But if you want to do anything "serious," you have to make a number of adjustments to the financial statements which Compustat doesn't make for equity earnings and unusual items and so on. And Compustat doesn't go back and restate. I think they might go back for one year but clearly if companies have made acquisitions or had divestitures, you want to look at a five to seven year trend, you're not going to really be able to do that accurately by using a Compustat. And so much information about a company is in the footnotes which isn't captured in the Compustat or other databases; you're missing maybe two-thirds of the picture if you're just relying on the database. **[TC 3/11, p. 55]**

Participant C-5
We're not completely reliant on databases; we do have individual analysts. I would also suggest that you're talking about a process that's going to evolve and be making or suggesting changes that would exist three to five years from now. One of the things that Compustat is

working to include in its framework are the disclosures that are currently made. The users can make their determinations off these databases but I think what you should recognize is that it's almost impossible to look at usage today and talk about it. We are increasingly using our databases. For example, I'll use it to look at potential customers and also to assess a portfolio; for example, I'll have twenty shipping companies and I want to know the other twenty I don't have and I want to know where I sit in the industry. **[TC 3/11, p. 55]**

Participant C-15
You're not making a lending decision based on that, though; you're using it for other purposes? **[TC 3/11, p. 55]**

Participant C-5
For portfolio management, for strategy, target. There's so many uses for this information and the supplemental disclosures about delinquencies, receivable agings and so forth that are not available because it's not prescribed accounting format. **[TC 3/11, p. 55]**

Participant C-12
We make fairly extensive use of databases in looking at domestic and particularly foreign banks. A lot of it is to get this comparability as well as the first look. But I'm not looking at one bank in isolation, I'm looking at it in the context of how they're doing compared to their peers. And a lot of the analysis is peer-based and I don't want somebody to spend a lot of time pulling together numbers necessarily because even then I have to worry about whether my junior person pulling together numbers did as good a job as IBCA(ph) does when they put together a foreign bank database? **[TC 3/11, p. 56]**

Committee/Staff/Observer
So your tolerance for the things that [participant C-1] ran into is high simply because it's using them at a very aggregate level? **[TC 3/11, p. 56]**

Participant C-15
There's also a real difference between looking at a bank which maybe lend itself to a lot more statistical comparisons and a high yield company where it's a lot more subjective. **[TC 3/11, p. 56]**

Participant C-13
Our use of databases is pretty similar to the last two comments in that we use a number of them fairly extensively. And I'm not entirely comfortable with the accuracy of all the data or the amount of adjustments that are necessary. But we don't use it for an individual credit decision. We're screening, we're comparing, we do things like: what's the average of these ratios for the average A rated credit? And then look at where this company is or what's the average coverage ratios in this industry and similar kinds of things like that. **[TC 3/11, p. 56]**

Participant C-4
Are you referring just to external packages or internally developed databases as well? **[TC 3/11, p. 56]**

Participant C-12
I think at the moment we were looking for information that came in on the database as opposed to databases you would have developed in turn. **[TC 3/11, p. 57]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 16

We understand that investors and creditors are increasingly purchasing databases that include information taken from external reporting. For example, those databases may include condensed financial information for a number of years or quarters and for a number of companies.

a. Do you currently use purchased databases in your work?

YES *3*
NO*2*

If YES, which of the following identify your reasons(s) for using a purchased database? (Please check *all* that usually apply.)

1. The database provides information on companies for which I *do not have financial information*.	*3*
2. The database helps compute aggregate *ratios and other statistics for groups of companies and industries*.	*3*
3. The database *helps compare* one company with others or industry averages.	*3*
4. The database provides *quick means to check data and make comparisons* with little investment, but it does not provide the information needed for full analysis of a company's financial circumstances.	*3*
5. The database helps me identify *companies for further consideration* (e.g. prospects for investing opportunities).	*2*
6. The database allows me to allocate my time efficiently.	*3*
7. The database is used by clients, so I need to be cognizant of the information contained in the database.	*1*

8. Something else. Please describe:	

b. Which of the following describe any *disadvantages* you encounter with purchased databases? (Please check *all* that apply.)

1. Databases are generally not updated on a timely basis.	*2*
2. The data are too often incorrect.	*2*
3. The data are too condensed or are otherwise incomplete.	*1*
4. The data are too standardized in categories that do not reflect the true economic nature of the amounts reported.	*2*
5. I have no significant problems with databases.	
6. Something else. Please describe:	*Participant I-9:* Poor adjustment for acquisitions or sale of business segments.

c. Even if you rely somewhat on a database, do you always refer to a company's external reporting when analyzing a company? That is, do you ever use the database as a substitute for a company's external reporting? (Please check only ONE.)

1. I always refer to the company's external reporting when analyzing a company. Purchased databases are a supplement to, rather than a substitute for, external reporting.	*4*
2. I only use databases; I don't refer to the company's external reports.	
3. Sometimes a database is an effective substitute for portions of a company's external reporting. (Please briefly describe in what circumstances you are willing to use a database as a substitute for external reporting.)	*Participant I-7:* Where ratios are offered, its a major timesaver. *Participant I-10:* Per Share data (sales, cash flow)

[PMQI 3/17, p. 29-30]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 16

We understand that investors and creditors are increasingly purchasing databases that include information taken from external reporting. For example, those databases may include condensed financial information for a number of years or quarters and for a number of companies.

a. Do you currently use purchased databases in your work?

 8 YES 5 NO

Participant C-4: D&B Financial Ratios.

Participant C-9: No, but I would like to for the reasons in 2, 3 and 4 below.

If YES, which of the following identify your reasons(s) for using a purchased database? (Please check *all* that usually apply.)

6 1. The database provides information on companies for which I *do not have financial information*.

7 2. The database helps compute aggregate *ratios and other statistics for groups of companies and industries*.

7 3. The database *helps compare* one company with others or industry averages.

7 4. The database provides *quick means to check data and make comparisons* with little investment, but it does not provide the information needed for full analysis of a borrower's financial circumstances.

6 5. The database helps me identify *companies for further consideration* (e.g. prospects for lending opportunities).

3 6. Something Else.
Please Describe:

Participant C-8: Provide older data or current opportunities.

Participant C-13: The database allows me to screen a large number of companies for potential investments (not quite the same as five).

Participant C-14: We never fully rely on data-base numbers.

Participant C-12: The database allows us to eliminate from further consideration any obviously weak performers. To the extent a quick response is desirable and to the extent that credit resource allocation is important, a fast "no-go" is a good decision.

Participant C-11: Databases do not do a good job on financial companies. If I used them for other sectors, I would check 4.

b. Which of the following describe any *disadvantages* you encounter with purchased databases? (Please check *all* that apply.)

_7_ 1. Databases are generally not updated on a timely basis.

_4_ 2. The data are too often incorrect.

_2_ 3. The data are too condensed or are otherwise incomplete.

_3_ 4. The data are too standardized in categories that do not reflect the true economic nature of the amounts reported.

_2_ 5. I have no significant problems with databases.

_0_ 6. Something Else.
Please Describe:

Participant C-13: We are prepared to rely on database output in identifying companies to which we lend at short-term - i.e., up to 180 days - using very conservative criteria.

Participant C-14: Not always sure what is in a specific number.

c. Even if you rely somewhat on a database, do you always refer to a company's external reporting when analyzing a company? That is, do you ever use the database as a substitute for a company's external reporting? (Please check only ONE.)

_6_ 1. I always refer to the company's external reporting when analyzing a company. Purchased databases are a supplement to, rather than a substitute for, external reporting.

_0_ 2. I only use databases; I don't refer to the company's external reports.

_3_ 3. Sometimes a database is an effective substitute for portions of a company's external reporting. (Please briefly describe in what circumstances you are willing to use a database as a substitute for external reporting.)

Participant C-12: Very low risk trades/time-sensitive/one-time only. For example: Can we sell today $2 million for Deutsche marks, for delivery in 2 days, to Bank A? To verify that Bank A exists, is of sufficient size, and reported sufficient capital and good earnings, is sufficient to approve the trade.

Participant C-17: Well backed (Baa2 or better) public companies when supplemented by industry and agency reports (D&B - Value Line, for example) and bank checks - especially when operating under a compressed time frame due to competitive pressure.
[PMQC 3/11, p. 25-27]

16(a). Databases--Page 16

[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:

- Change is occurring so rapidly that well informed, readily available investor contact is crucial. [Also included in 15]
- Strategic input from top management, communicated in annual reports, meetings, and or by other means. [Also included in 15]

[AIMR/CIC91, p. 2]

16(b). Other

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 1(c)] **[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 1(c)] **[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 1(c)] **[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 1(c)] **[TOWERS PERRIN, p. 7]**

Videotape, audio tape, personal computer diskettes, and on-line access to a service organization are not attractive options for most individual investors. Videotape and audio tape are seen as too inflexible and somehow not appropriate for investment information, and even less so for the annual report. The other two options require computer literacy and access to appropriate equipment--capabilities that are not yet typical among the individual investors interviewed. [Also included in 15 and 16(a)] **[SRI, p. 69]**

Professional investors express a different level of interest and are more computer literate. When asked, "Would receiving company information in any of the following ways be useful to you?" their responses were as follows: [Also included in 15 and 16(a)] **[SRI, p. 69]**

	Yes	*No*
On videotape?	34.9%	64.7%
On audio tape?	31.4	68.6

On diskettes for your personal computer?	60.9	38.8
From on-line access to a service organization?	67.6	32.1

[Also included in 15 and 16(a)] **[SRI, p. 69]**

Videotape is seen by all professionals except retail stockbrokers as inflexible, and not at all useful for investment analysis; audio tapes are thought to be even less useful. Retail brokers see the possibility of using videotapes in the sales process. [Also included in 15 and 16(a)] **[SRI, p. 69]**

Diskettes for personal computers have initial appeal, but concern about their usability prevails. To ensure compatibility with various computers, the diskette would have to be created in one or a very few standardized formats. In addition, most professionals, especially the analysts, have developed individualized approaches to security analysis. These problems are more perceived than real, however. As these technologies become better understood and more widely available, the personal computer will become an increasingly important element in financial information distribution. [Also included in 15 and 16(a)] **[SRI, p. 69]**

On-line information is appealing to all segments of professional investors. Most analysts, surprisingly, are not aware of the SEC's experiment with EDGAR (Electronic Data Gathering and Retrieval). As EDGAR is just such an on-line service, professionals are likely to receive it with enthusiasm. [Also included in 15 and 16(a)] **[SRI, p. 69-70]**

Ultimately, the needs of investors will shape corporate financial communications, including the annual report. In the long run, the market power and welfare of investors will guide the policymaking of regulators, the communications and investment vehicles offered by corporations, and the applications of technology in the investment field. By better understanding the investors' information requirements, corporations can mold the annual report and their other communications to achieve an even more productive and profitable relationship. **[SRI, p. 73]**

Last year the [CIC] Computer and Electronic Subcommittee noted growing use of new communications technology in company/analyst relationships. This year electronic communication:

> . . . emerged as a critical and timely way of communicating with investors. Included . . . were electronic bulletin boards, complete release of quarterly information on Business Wire or the First Call service, video transmission of presentations at the New York Society of Security Analysts, and quarterly conference calls. The techniques were particularly important in the industry because the pace of change was accelerated and it was increasingly critical that all investors be treated equally and that the general public also have relatively quick access to important information. Much of the coordination of these

> efforts fell to the investor relations staff or function. The subcommittee, therefore, felt justified in increasing the importance of the weighting of this critical effort.

[AIMR/CIC90, p. 1-2]

[A] number of [CIC] subcommittees noted a trend toward improved communication on the part of many companies. While many companies are to be commended for meeting this obligation, there is still room for considerable improvement. **[AIMR/CIC92, p. 1]**

[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 2(b)] **[AIMR/CIC92, p. 1]**

[The CIC has commented that] while the annual report remains the primary corporate communication and the quarterly report ranks very high, there is increasing emphasis on "extra efforts" put forth by management. The "factbook" with up to ten-year financial records continues as the most respected extra. Timely and meaningful press releases covering important developments are often cited. Quarterly conference calls and analyst meetings are also becoming more important and may well reflect growing investor concern for short-term "market performance." Many investors cite the absence of a separate fourth quarter report as a continuing sore point. Fax machines are a wonderful tool for the rapid dissemination of hard copy data but this newer means of distribution is often overworked. We stress again that corporate communications should not be confined to the professional investment community but also directed to the general investing public. [Also included in 11(b) and 15] **[AIMR/CIC92, p. 2]**

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 2(a), 11(a), and 15] **[AIMR/CIC92, p. 3]**

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), 5(d), 11(a), and 13)] **[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]**

17. Auditor Involvement

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	□

17(a). Benefits and Criticisms of Audits

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]**

- Standards for auditing and other professional accounting services should be established and maintained in the private sector, not by a governmental or regulatory body. To ensure consistency and understandability, the APC [Accounting Policy Committee] believes there should be a single set of generally accepted auditing standards (GAAS) determined by a single rulemaking body. [Footnote reference omitted] **[RMA90, p. 9]**

- There should be one standard of work quality for judging all public accountants, such standard to be set forth in the professional accountants' code of ethics. Levels of performance exceeding this acceptable quality standard may, however, be required by certain regulatory agencies. **[RMA90, p. 9]**

- In addition to determining and reporting whether or not financial statements comply with generally accepted accounting principles, independent auditors have the responsibility to evaluate the overall fairness of financial statements (including the viability of the going concern) and their freedom from material misstatement. These responsibilities emanate from the auditor's access during the audit process to financial and related data not available to third-party users of the statements. **[RMA90, p. 9]**

- Financial statement reliability is enhanced when the statements are attested to by certified public accountants (CPAs) whose examinations were made in accordance with GAAS. Reliability and credibility decreases as the level of assurance provided becomes less positive. Uncertainties in the mind of bank lenders increase as the credibility of the financial statements decreases; increases in uncertainty generate increased risk; and, increased risk usually results in increased borrowing costs. **[RMA90, p. 10]**

- The APC [Accounting Policy Committee] believes that auditors should recognize that their services are performed primarily for the benefit of third-party users of financial statements. The legal doctrine of "privity", that third-party users cannot rely on audited financial statements unless they are named in the contract between the auditor and the company being audited, is inimicable to the interests of all three parties. **[RMA90, p. 10]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. During the discussion of the types of information investors use to achieve their objectives, one participant mentioned a benefit of having audited financial statements.

Participant I-9
We tend to believe what we see in the audited financial statements from any of the major firms. If something would put us on notice, like an aging of receivables where receivables are beyond the normal trade terms, it would be very helpful to us. There are some industries where management is very truthful, there are other industries where managements lie. The movie business, the discount companies, the textiles are less truthful than the drug industry most of the time. The point is we think your responsibility is equal to us as investors as it is to the Board of directors that you're reporting to and you should know these industries very well. Put us on notice to ask the proper questions rather than treat the financial statements of a third rate retailer the same as you would for [name deleted]. [Also included in 17(b)] **[TI 10/16, p. 20]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Committee/Staff/Observer
Our first seven questions deal with auditor involvement with external reporting. Question 1 asks: What are the benefits, if any, of an audit of financial statements that are most beneficial to your work? That is, what aspects of current auditing would you be most willing to lose, if any? In responding please consider audits only as currently performed. Do not consider what auditors could do, for that is the subject of a later question. **[TI 3/17, p. 2]**

Participant I-7
I'm not a CPA; I only have anecdotal evidence through my daughter who is a CPA. The audit procedures on revenues are very vital, as well as for inventories, receivables and payables. I count very heavily on the fact that these key elements in my work have been checked (not necessarily every item) by the auditors. **[TI 3/17, p. 2]**

Participant I-12
I find the greatest use of auditing in that there is a certain reliability given to the financial statements and a certain standard that we feel we can rely on. **[TI 3/17, p. 2]**

Participant I-11
Having the knowledge that a presumably independent professional has examined the books and hasn't found any material misstatement is what is of value in the work auditors do. **[TI 3/17, p. 2]**

Committee/Staff/Observer
Is there anything implicit in the auditors' role that you would be most unwilling to lose? **[TI 3/17, p. 3]**

Participant I-11
It's a package. If I lose any part of it, I lose the whole thing. **[TI 3/17, p. 3]**

Participant I-16
I describe it naively as one more conscience reviewing the financial statements before they go out. Maybe it's a conscience or maybe it's someone who has a liability insurance policy. **[TI 3/17, p. 3]**

Committee/Staff/Observer
[Participant I-16], how important is that liability insurance policy to you? [Also included in 18(b)] **[TI 3/17, p. 3]**

Participant I-16
I think it's very important. There has to be some accountability. I'm not in favor of lawsuits but unless somebody suggests another way to make auditors accountable, I think we have no choice. [Also included in 18(b)] **[TI 3/17, p. 3]**

Committee/Staff/Observer
Your affection for the liability is to put a burden of responsibility on the auditor as opposed to the ability to collect financial benefits? [Also included in 18(b)] **[TI 3/17, p. 3]**

Participant I-16
Yes. [Also included in 18(b)] **[TI 3/17, p. 3]**

Participant I-7
If there's a significant mistake on the part of the profession, then liability is called into action; there's a reason for it. The investor who has taken the statements as a basis for making an investment should benefit by that particular liability. [Also included in 18(b)] **[TI 3/17, p. 3]**

Participant I-16
And the liability has to be tempered by what was involved. Was this just not the greatest work in the world, which isn't a huge liability; nobody guarantees that they're perfect. If there was some kind of collusion, then the liability is quite clear. [Also included in 18(b)] **[TI 3/17, p. 4]**

Committee/Staff/Observer
I don't think anybody disagrees on the latter, criminal intent and things like that. [Also included in 18(b)] **[TI 3/17, p. 4]**

Participant I-16
But the standards of performance are subject to some sort of debate. [Also included in 18(b)] **[TI 3/17, p. 4]**

Participant I-7
Isn't there some debate on the RICO act relative to the profession? Wasn't there something recently indicating that the profession may not be subject to the RICO act? [Also included in 18(b)] **[TI 3/17, p. 4]**

Committee/Staff/Observer
There was a court case a week or 10 days ago that came down in favor of [name deleted] that said that RICO was intended to go after organized crime, not organized accountants, and that it just went too far in that case. Good plaintiffs counsel have used RICO for 10 years as a sword over the profession. This is the first major case that said that it doesn't apply. [Also included in 18(b)] **[TI 3/17, p. 4]**

Participant I-7
They have done it in our industry also. [Also included in 18(b)] **[TI 3/17, p. 4]**

Committee/Staff/Observer
Our second question deals with any disappointments that you have with audits and audit reports on the financial statements. That is, what should auditors do better in auditing and reporting on the financial statements that you would find helpful in your work? In responding to this question, please consider only audits as currently defined. Whether the auditors' role should be expanded is the subject of a future question. **[TI 3/17, p. 4]**

Participant I-16
One of the things that bothers me is the auditors' current position of either saying "good housekeeping-seal of approval" or "there's something that bothers me here". I presume that in looking at a lot of different clients, the auditors get some idea of where there are choices to be made, either in terms of what principles you chose to apply, or the types of conservatism embodied in estimates. It would be very helpful if auditors could give us some sense, on a qualitative basis, for all companies, at least in broad bands, of how a company's practices compare against its peer companies. It would be better than to say that 99.9% of companies are O.K. and nothing more is said other than this packaged audit statement. [Also included in 17(c)] **[TI 3/17, p. 5]**

Participant I-7
We have discussed in previous meetings that in going through your procedures, estimates were made so that not everything is specific to the dollar. Estimates are made in your audit procedures that are of such significance that, if a different route had been chosen, there may have been a material change in the end result. We'd like to know about that. [Also included in 9 and 17(c)] **[TI 3/17, p. 5]**

Participant I-12
Where the greatest problems have come up is when the auditors have to rely on assertions and opinions of management. In a world that is changing as rapidly as ours, managements are highly capable of misleading themselves. I'm not sure if this is really the arena in which auditors should work, but it seems to be where I've seen the biggest issues come up. For example, everyone is sort of going along business as usual, then there's a major change in the environment, and nobody catches the fact that this will have a material effect in terms of the financial statements. [Also included in 9] **[TI 3/17, p. 5]**

Committee/Staff/Observer
How would the auditor get involved in that? How is that a disappointment in auditing? **[TI 3/17, p. 5]**

Participant I-12
I'm not even sure that that's the arena of the auditors. I harked back to the change in tax law in 1986 which had enormous implications on the future of real estate partnerships. One would think that perhaps such things should be given more prominence in the financial statements or audit reports. Things of that nature should somehow be highlighted. [Also included in 9 and 17(c)] **[TI 3/17, p. 5-6]**

Committee/Staff/Observer
[Participant I-12], is it an audit issue or an accounting issue? To the extent that the accounting is driven by management judgments or decisions, is that maybe where your concern is? Or is your concern with respect to auditors auditing the subjective and the intangible? [Also included in 9] **[TI 3/17, p. 6]**

Participant I-12
It seems to me that it's all wrapped up together. The accounting profession is accounting for various transactions and that gets colored by whatever the current rules are; if you change the rules, the accounting will change. So it is an accounting issue. There is also an auditing element in that the auditors ought to be caught up with those changes and changes in the environment, and they should have a role to play in the reporting process. But I don't know what that role is. [Also included in 9] **[TI 3/17, p. 6]**

Committee/Staff/Observer
It sounds like what you and [participant I-16] are saying is the same. Our audit report now is kind of a one-size-fits-all report, very standardized. But the world is becoming more and more subjective, decisions have to be made more rapidly, and the impact on longer term assets is more and more uncertain; so it would be useful if the audit report could reflect that environment. [Also included in 9 and 17(c)] **[TI 3/17, p. 6]**

Participant I-16
When I first became a financial analyst 20 years ago, the major concern one had was the choice of accounting principles of management and how they could affect the numbers. Over the last 5 years, we know that what's really important are the estimates. When you see the enormous write-offs that companies have made in the last few years, they're basically saying that for years they have overstated their earnings by making bad estimates. Yet, auditors have not acknowledged that problem in their report. They also do not acknowledge when a company, every year for 5 straight years, has a huge write-off of assets in the fourth quarter, which says that they have been misleading people for eternity by capitalizing expenses. [Also included in 9 and 17(c)] **[TI 3/17, p. 6-7]**

Participant I-12
I'm not sure that management is deliberately misleading people. One of my issues with accounting and auditing is the use of assumptions and estimates and making those transparent. Because they're not always transparent to an analyst. There is a lot of room to change the appearance of financial statements based on the assumptions and estimates. [Also included in 9] **[TI 3/17, p. 7]**

Participant I-11
I'm going to make a radical statement. As audits are currently performed and reported, I think auditors do a very good job. If you define the audit assignment as what it is defined today, I think by and large the quality of audits is excellent. What most of us have been talking about in these sessions is less whether auditors are doing well what they're doing now, but whether there are other things they should be doing. [Also included in 17(b)] **[TI 3/17, p. 7]**

Participant I-12
Some of my compatriots and sometimes even I have wondered about the independence of auditors. The outside accounting firm staff lives in the company for lots of the companies I deal with because those companies are so large and so complex. It's a concern. **[TI 3/17, p. 7]**

Committee/Staff/Observer
What causes you to wonder? **[TI 3/17, p. 7]**

Participant I-12
If an auditor is sitting at a desk in [a company], looking at statements and working with the same people day in and day out, that person knows those people very well. He may begin to feel more like an employee of [that company] than the auditing firm. I don't know if that's true and I would agree with [participant I-11] that, for the most part, auditors do a very good job. But I know my compatriots have raised this issue from time to time: just how independent are the auditors? **[TI 3/17, p. 8]**

Participant I-7
Our profession, certainly the sell-side, has the same independence problem. When given the choice of two directions, unless the liability issue is significantly raised, the auditor, like the analyst, will take the choice that is more favorable to management. [Also included in 18(b)] **[TI 3/17, p. 8]**

[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 auditor involvement.

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 1(b), 11(c), and 13] **[TC 12/8, p. 52-53]**

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 2(d)] **[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 2(d)] **[TC 12/8, p. 56]**

[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 auditor involvement.

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 4] **[TC 2/2, p. 8]**

Participant C-17
I'm not going to have some guy (management) come and tell me <u>this</u> is what he thinks his business is worth, without any kind of independent verification. [Also included in 4] **[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 4] **[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 4] **[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 4] **[TC 2/2, p. 9]**

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 5(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 display. During the discussion, comments were made on auditor involvement.

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 5(a)] **[TC 2/2, p. 15]**

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 5(b)] **[TC 2/2, p. 19]**

Participant C-17
Kinds of stuff that would come to my mind [for disclosure] 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 5(b) and 13] **[TC 2/2, p. 19-20]**

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 5(b)] **[TC 2/2, p. 21]**

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 5(c)] **[TC 2/2, p. 25]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Committee/Staff/Observer
The first question is what do you gain most from an audit or what would you least like to lose? **[TC 3/11, p. 1]**

Participant C-10
The thing I'd be most unwilling to lose would be the feeling of independence. That's really critical to understand that the auditors are not subject to being influenced by managements. I'd like the assurance that they have been able to test reasonableness. So I guess maybe my point there is reasonableness. That ties in with the independence, but it's the other side of it. **[TC 3/11, p. 1]**

Participant C-5
The concept of confirmations and physical counts and so forth is valuable. Whatever work we do is typically based off management's internal financials and looking at concentrations of receivables or inventories. But we always lean back on the fact that the auditors have done those confirmation procedures and verification procedures. In the context of middle market lending, that's the most valuable aspect of it. The one that we don't do. **[TC 3/11, p. 1]**

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 2(c)] **[TC 3/11, p. 1]**

Participant C-2
The whole assurance factor certainly encompasses some of the other points that are made here. That internal controls have been reviewed, and hopefully management is being counseled as to

where there may be weakness. And just the conformity to GAAP and the assurance that that provides the creditor. **[TC 3/11, p. 2]**

Committee/Staff/Observer
[Participant C-2], is it assurance with respect to the financial statements and paper you get? Or assurance with respect to the relationship of the company to the auditor and whatever that's conveying between the two? **[TC 3/11, p. 2]**

Participant C-2
To me, I don't see that second relationship as much as being encompassed in the way I think about assurance, but it would certainly encompass the independence concept that was mentioned. Assurance that an independent, unbiased, knowledgeable expert has come in. Through their testing and sampling and so forth, they have looked at enough transactions, traced them through, confirmed receivables, ensured consistency from period to period. Those kinds of assurances. **[TC 3/11, p. 2]**

Participant C-4
The most important thing that the auditors do obviously is external verification of documents and balances. We also rely very heavily on an audit to uncover material weaknesses in internal controls and procedures. And we also like the fact that with an audited financial statement, we have the ability to sue CPAs. **[TC 3/11, p. 2]**

Participant C-14
I think an important area where we look to the auditors is on contingent liabilities. I'm not sure the extent of the work is enough, but there is some comfort that we take in knowing that the auditors have weeded through the various legal contingencies and determined materiality of the ones they'd looked at. And that, with regard to the potential liabilities, have conferred with the company's counsel, and come to a determination of how much potential liability there is. Again, there probably could be more work in that area, but I think what's done there now is important. **[TC 3/11, p. 2-3]**

Committee/Staff/Observer
How many others see the world as [participant C-4] sees it? [Also included in 18(b)] **[TC 3/11, p. 3]**

Participant C-5
I would say we're exactly the opposite. We have not pursued that avenue in any situation and it just doesn't even enter into our judgement. We're looking for more the assurances as to the practice and the procedures, and have never really looked at the depth of the pockets. So, I would take almost a contrasting view that it just doesn't even enter the thinking process. [Also included in 18(b)] **[TC 3/11, p. 3]**

Participant C-11
I think it's good to know that the auditors must be nervous about the fact that somebody might sue them, and use a little bit more diligence than they might otherwise do. So I think the auditors should feel a little nervous. That they'd better really get into the stuff or they might

be sued. I think that is helpful. On the internal controls, I do think that there's some difficult areas that I would want to feel comfort about, as to what kind of examination really did take place. And I'm thinking of some of these huge off-balance sheet items, such as the foreign exchange contracts, hedging type things. I think it's an interesting avenue to think about. The standard audit letter does not give any feeling one way or another that the critical areas have been looked at in depth. [Also included in 17(c), 18(b), and 19] **[TC 3/11, p. 4]**

Participant C-4
Just one other point about the ability to sue auditors. We see that more as a club, and as a possible incentive for auditors. We, in a number of instances, find situations where a CPA may be reluctant to change from a review to an audit, because of some of their concerns. And that provides useful information for us in those instances. So, the real use is as a lever against the auditor. [Also included in 18(b)] **[TC 3/11, p. 5]**

Committee/Staff/Observer
Question 2. Now that we have explored the things that we wouldn't want to give up, what things might we want to improve upon? What has been the greatest disappointment to you in terms of using audited information? **[TC 3/11, p. 7]**

Participant C-11
I should preface this by saying I'm not exactly sure what goes on in individual audits. And I have a sense that some improvements that I'm going to mention are already beginning to occur. Anyway, I think that the traditional focus has been on the micro- individual transaction verification. I think that the audit should be directed from the point of view of where the risks are, on an aggregate basis, a macro basis. And how are they measured, from a credit point of view and whether that process is good because so much is dependent on systems now. So, that is one thrust of what is in my mind. A second thrust is also macro. I think that many opinions that auditors have to ultimately make have to do with going concern and impairment, and things like that. I do not think that the accounting profession is trained to think as broadly as it has to about how to determine and think about those issues. I think that the security analysis discipline is needed more and more by the auditing firms as they look at some of these very critical issues. So many of the failures that we've had -- I am not speaking now about fraudulent, but about more blatant conceptual failures, such as the S&L's -- in my mind have come because everything was looked at but people forgot to understand what the business was and how badly it was being managed. And maybe a third point is that outside users want independence from auditors. But there is a real question here, as to whether the auditors are always truly independent or are, by business pressures, more concerned with maintaining customer relationships. As opposed to be willing to stand back and say: "this company is going down the tubes." Those are broad comments but they are at least in my mind some of the problems that may have brought us to difficult audit conclusions in the past. **[TC 3/11, p. 7-8]**

Participant C-12
I would agree very much with the idea that the pressure of maintaining a good business relationship clouds the independence of auditors. Most of my work with auditors comes in due diligence sessions, where you sit down with somebody and they explain how fine everything is

and how accurate everything is. And we're doing this in presence of the company's management. I know that there's just a real lack of independence. And I understand, because I'm often in the same position myself. You know there is real pressure to maintain that relationship. I don't have an answer to how you fix that, but it seems to me that independence is a very difficult thing to maintain in a very competitive business world. I think while it's important to look at macro issues, I'd echo what people said earlier, that I'd really count on the auditors to do the micro issues as well. Because I can't do that. In some ways I can do some of the macro things myself. **[TC 3/11, p. 8]**

Participant C-5
The role of the auditors of our bank has shifted to much more forecasting, reviewing our forecast, our projections, and so forth. They also opined on our reserves quarterly. My value in the auditors is to understand where we think we're going, and to issue financial statements that allow the user to having that same understanding, to decide for themselves. If you've got a concern about Texas real estate and the thrift is in Texas, I would like to know how much of the real estate is in Texas, as opposed to maybe up in Colorado or in Pennsylvania. And so the presentation of financial statements needs to be designed that way. The supplemental financial information would need to be designed in a way that the user could make their own determinations about the projections, forecasts, the future direction of the company. What I found, however, is in going forward, as auditors have had to put opinions on projections, they've applied a conservative bias. As creditors, we create a best case, which is our sort of operating assumption, very different from what management projects itself -- their management case. We then have a worse case. We've got three case scenarios. I don't need the auditor to give me the worst case. I need to know the legitimate case. And actually I struggle at times, because I really almost don't want their opinion; I want them to give me an update so that I can have my own opinion. And I don't get that out of the financial statements. The conservative bias has created a philosophy around our bank to lend on forecasting that's not the most accurate forecast or the best estimate, but the most conservative estimate of a forecast. That's not what creditors really need. They'll do that themselves. [Also included in 17(b)] **[TC 3/11, p. 8-9]**

Participant C-14
I agree with that [that is, the auditors should not interpret and analyze the information] because I think it would even put more pressure and cloud the objectivity of the auditors. You have to have a base of some kind, to not only judge the accuracy of the information, but then state an opinion on it. I think the kinds of things they could do is more focus on validating , for example, asset values. It is an area that has been a disappointment. When a company comes out and does an inventory or asset write down, the first thing that goes through your mind is: "Well, where were the auditors in validating the presented numbers on the balance sheet on this?" [Also included in 17(b)] **[TC 3/11, p. 10]**

Committee/Staff/Observer
Are you saying that auditors aren't asking the reasonableness question? Or are not asking it enough? Or asking it correctly? [Also included in 17(b)] **[TC 3/11, p. 10]**

Participant C-14
I'm basing my opinions on empirical evidence. I'm not saying that what you do isn't right, but I'm saying that it's not working, because we see companies -- [names deleted] -- doing their every year restructuring and write-downs. If the auditors aren't onto [name deleted] by now, you know, they're missing something. So I'm sure that the work is appropriate and it's adequate, in terms of validating that the procedures that [name deleted] uses to account for its asset values are GAAP. But then I think the auditors have to step back and say: "Does that number look right?" Based on the profitability relative to other people in the industry, are those asset values they're carrying in line with the cash flow earnings they're generating? And I would say that holds for inventories as well. [Also included in 17(b)] **[TC 3/11, p. 10]**

Committee/Staff/Observer
Okay. And then, going from that standard of performance [that you expect from the auditors] and looking at question number two, do you have some disappointments in that regard? **[TC 3/11, p. 11]**

Participant C-13
In retrospect, the comments that [participant C-14] just made about continuous write-downs and asset values cause the outsider to question the accuracy and reliability of the numbers that were previously presented and cause the loss of confidence in the ones that are currently being presented. **[TC 3/11, p. 11]**

Participant C-1
I think that's the real issue: is the data really independently observed? And from my standpoint, in terms of work-outs, I can tell you that I don't think it is. If you have accountants who are doing audits for minuscule amounts of money, or zero profit, who are then coming in and doing consulting work, work-out work, executive comp work, how can that possibly be independent? Also, the quality of audit is so varied. And the quality of the people doing the audits is so varied. In some cases, the way they audited the inventories or the receivable is wrong, or it's not accurate, or they haven't spent enough time. [Also included in 17(b)] **[TC 3/11, p. 12]**

Committee/Staff/Observer
When you say the inventory was wrong, do you mean that it wasn't there, or that the cost of it was incorrect? Or do you mean that the company couldn't get the value that's on the balance sheet in a fire sale? [Also included in 17(b)] **[TC 3/11, p. 12]**

Participant C-1
We have, in retailing especially, a continuous change in strategy. And auditors seem to ignore the fact that inventory that has been there for three years is not going to be sold. And the cost is not a good price. And it doesn't get written down. It's a value question, and it's a question that if it's not getting sold, why is it still there as a current asset? [Also included in 17(b)] **[TC 3/11, p. 12]**

Participant C-4
I see a real problem with inventory and receivables consistently being carried as current assets when they are never realized in the current cycle. I think the hindsight review is inadequate in a lot of areas and on those items in particular. [Also included in 17(b)] **[TC 3/11, p. 13]**

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 2(c)] **[TC 3/11, p. 13]**

Participant C-6
At the level of the businesses that I deal with, which is on a much lower level than many of the people here, we strive to obviously get better than a compilation statement, and if we can get a review statement, well, we're very happy about that. But in many cases, we just get no disclosure whatsoever, that is, no footnotes, in a review statement. It's beyond me how an accountant can put out a review statement without putting any footnotes in the statement. Basic information, such as liens on assets, term loan covenants, inventory receivables are not discussed, and possibly bad receivables that may be in there. That's the most disappointing thing to me. When I strive to get a review statement, but get no footnotes, I think that's lacking. [Also included in 17(e)] **[TC 3/11, p. 13]**

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 5(b) and 9] **[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 5(b) and 9] **[TC 3/11, p. 14]**

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 2(d) and 17(e)] **[TC 3/11, p. 16]**

Participant C-2
I wanted to raise a different issue in answer to this question, and that is in terms of what's the greatest disappointment. The issue of privity and the underlying implication that unless you are in privity with the accounting firm, you may not rely on the information contained in the audit. When I was with a different bank, with a great number of banks in different states, we had a couple of banks in states where privity had to be established. And again, I want to tie on to the comments that have been made earlier: it is not a bank's intention necessarily to sue the accounting firm. However, you do always want to try to preserve your rights. And in those particular banks, we developed some credit policies to try to at least get the banks in privity with accounting firms but we had very little luck getting the accounting firms to return letters basically acknowledging that we were in receipt of the statements delivered by the customer, and could in fact rely on the information in the audits. I do feel that there should be some classes of statement users considered to be automatically in privity with the accounting firms. [Also included in 18(b)] **[TC 3/11, p. 16-17]**

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 5(b) and 17(b)] **[TC 3/11, p. 17]**

Participant C-11
I know the genesis of this question. It goes back to the previous discussion we've had. There's something wrong with many audits and so we need to find ways to get this subject out in the open. Whether this is an appropriate framework is not the point. It's about how we can improve the qualitative aspects of audits. [Also included in 17(d)] **[TC 3/11, p. 20]**

Committee/Staff/Observer
Let me make sure I understand your point. What the people who recommended this had in mind is: "Let's use this recommendation as a way to initiate discussions about quality of audits?" [Also included in 17(d)] **[TC 3/11, p. 20]**

Participant C-11
Yes. [Also included in 17(d)] **[TC 3/11, p. 20]**

Participant C-7
We've had experience with a number of our customers where we've gone back to them when they've come in with credit requests and said you've got to change your auditors or your accounting firm. We're dissatisfied with the quality of work. [Also included in 17(f)] **[TC 3/11, p. 29]**

[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 auditor involvement.

Participant C-11
I think this is a necessary component. If there is any value to the audit, there has to be the ability to go to court if something has not been done properly. The issue is a broader social issue. We have huge problems with product liability and malpractice liability. Whereas in earlier years people could do outrageous things and never get sued, now it's clearly the other way. And up until now, Congress has not found a way to have reasonable limitations on reckless court proceedings. But I don't think you can avoid the liability question and should not. [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 1

Below are several "*benefits of an audit*" discussed during our meeting or cited by others. Please indicate your degree of *agreement* or *disagreement* with each characteristic below as a description of ways audits are beneficial to users:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
a. An *independent perspective* of the financial statements.	*2*	*3*			
b. Assurance that someone has *examined (verified) objective evidence* supporting the amounts in the financial statements.	*5*				
c. Establishing someone else, in addition to the company, from whom *damages can be recovered* in the event that the financial statements are determined to be misleading. *Participant I-9:* This is too strong, but auditors who do a poor job should be penalized.	*1*	*2*		*1*	*1*
d. Assurance the company's system of *internal control is adequate*.	*1*	*4*			
e. Assurance that the company's *system of internal control* has been reviewed and criticisms/recommendations have been reported.	*2*	*2*	*1*		
f. Assurance that the *company will remain in business* for the foreseeable future.	*1*	*1*	*1*	*1*	*1*
g. Helping insure that *management feels a sense of accountability* to investors and creditors.	*1*	*3*	*1*		
h. Something else. Please describe: *Participant I-16:* Availability of non-management input to outside directors	*1*				

[PMQI 3/17, p. 3-4]

QUESTION 2

Below are several "*disappointments of audits*" discussed during our meeting or cited by others. Please indicate your degree of *agreement* or *disagreement* with each characteristic below as a description of ways audits have disappointed users:

SA - **Strongly Agree**
A - **Agree**
N - **Neutral**
D - **Disagree**
SD - **Strongly Disagree**

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
a. The *independence of auditors* from management is too clouded by their mutual business relationship.	*1*	*1*	*3*		
b. Auditors' *sense of materiality* is too high.	*1*	*2*	*2*		
c. Auditors' *procedures appear to be inadequate* because they too often fail to identify fraud or other errors in the financial statements.		*3*		*2*	
d. Auditors don't consider *issues on a broad enough scale*, such as context of the company within its industry and the nature of the markets in which the company operates, which results in overstatement of assets or understatement of liabilities.	*1*		*2*	*2*	
e. Auditors have *too conservative* a viewpoint; they need a viewpoint that is neither a best or worst case to avoid distorting financial statement estimates.			*3*	*2*	
f. Auditors fail to detect *uncollectible receivables or overvalued inventory*.	*1*	*3*	*1*		
g. "*Restructuring charges*" in financial statements, particularly on a recurring basis, raise questions about the effectiveness of audits to detect problems.		*4*			

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
h. Something else. Please describe: *Participant I-9:* The assumption is that auditors who learn of something materially important to assessing the value of a business will force management to at least mention this to shareholders. In most problem investments, the audited statements for past periods look fine going in but the seeds of destruction are known to management's investment bankers and, in some cases, auditors. Treasurers are financial watchdogs. Auditors should also be and not let management misrepresent the business.					

[PMQI 3/17, p. 4-5]

QUESTION 1

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

Below are several "*benefits of an audit*" discussed during our meeting or cited by others. Please indicate your *agreement* or *disagreement* with each characteristic below as a description of ways audits are beneficial to users:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

SA-7,A-5
__ a. An *independent perspective* of the financial statements.

SA-9,A-4
__ b. Assurance that someone has *examined (verified) objective evidence* supporting the amounts in the financial statements

SA-1,A-1,N-7,D-3,SD-1
__ c. Establishing someone else, in addition to the company, from whom *damages can be recovered* in the event that the financial statements are determined to be misleading

Participant C-4: Not so much for actual recovery, but the threat definitely improves audit quality!

SA-2,A-10,D-1
__ d. Assurance the Company's system of *internal control is adequate*.

SA-3,A-9,N-1
__ e. Assurance that the company's *system of internal control* has been reviewed and criticisms/recommendations have been reported

SA-1,A-4,N-2,D-3,SD-3
__ f. Assurance that the *company will remain in business* for the foreseeable future

A-4,N-6,D-3
__ g. Helping insure that *management feels a sense of accountability* to investors and creditors

SA-1
__ h. Something else.
Please Describe:

Participant C-14: Accounting systems have been tested to the extent that there is a high level of confidence on the part of the auditor that the financial statements represent reality (all actual accounting events) in accordance with appropriate accounting treatment (GAAP).

Participant C-11: F is an important point. This should be true. I do not believe that accountants have properly addressed this in the past - or used the right tools to do so.

Participant C-17: F. above - do want and need going concern qualifiers along with descriptive text as to issue involved.
[PMQC 3/11, p. 1-2]

QUESTION 2

Below are several "*disappointments of audits*" discussed during our meeting or cited by others. Please indicate your *agreement* or *disagreement* with each characteristic below as a description of ways audits have disappointed users:

SA - Strongly Agree
A - Agree
N - Neutral
D - Disagree
SD - Strongly Disagree

SA-2,A-8,N-1,D-2
__ a. The *independence of auditors* from management is too clouded by their mutual business relationship.

Participant C-14: Every profession has potential conflicts.

Participant C-4: Move toward creditors engaging auditors should be considered.

A-3,N-5,D-5
__ b. Auditors' *sense of materiality* is too high.

SA-1,A-6,N-4,D-2
__ c. Auditors' *procedures appear to be inadequate* because they too often fail to identify fraud or other errors in the financial statements.

Participant C-4: In some instances, no audit basis for estimates - % complete.

A-6,N-3,D-4
__ d. Auditors don't consider *issues on a broad enough scale*, such as context of the company within its industry and the nature of the markets in which the company operates, which results in overstatement of assets or understatement of liabilities.

SA-2,A-1,N-1,D-9
__ e. Auditors have *too conservative* a viewpoint; they need a viewpoint that is neither a best or worst case to avoid distorting financial statement estimates.

SA-3,A-8,N-1,D-1
__ f. Auditors fail to detect *uncollectible receivables or overvalued inventory*.

Participant C-4: Or disclose as non current.

SA-1,A-1,N-6,D-4
__ g. Auditor assertion of "*privity*" makes seeking auditor accountability difficult.

SA-3,A-1,N-3,D-6
__ i. "*Restructuring charges*" in financial statements, particularly on a recurring basis, raise questions about the effectiveness of audits to detect problems.

Participant C-14: Auditor signs off and shortly thereafter – huge asset writedowns. How can this be?

A-1
__ j. Something else. Please describe:

Participant C-8: On the low end, there is the problem of auditors working in industries which they know little about. The same CPA might audit a grocery store one day and a construction contractor the next.

Participant C-11: Comment on i - The problem is more that accounting policy has not provided standards on impairment.

Participant C-4: An audit states that the financial statements and notes are the responsibility of management. In theory, yes - in practice, for companies under $10 mm of sales, the auditors do the financials in a number of instances.

Participant C-17: Statistical sampling and depth of review are not described and are therefore suspect or it is hard to evaluate what degree of reliance is appropriate.
[PMQC 3/11, p. 2-4]

17(b). The Scope of Auditing

[Context] Meeting of the Investor Discussion Group on October 16, 1992. Throughout the meeting, when investors discussed their objectives and approaches to evaluating equity securities, comments were made on the scope of auditing.

Participant I-9
I hope that the accounting profession will look at the things that are suspect; for example, for a toy company, look at the receivables and make sure the goods can't be returned after Christmas; for a supermarket chain with lots of leases, make sure the discounted present value of the leases is a fair number; if [name deleted] is using a lower inflation rate on health care benefits to discount because the company would be insolvent if it used a current discount rate, I want to know this. So look at what is of significance for making an investment in a particular industry and don't let the companies bamboozle the profession because it is in their best interest to do so. **[TI 10/16, p. 6]**

Participant I-9
We tend to believe what we see in the audited financial statements from any of the major firms. If something would put us on notice, like an aging of receivables where receivables are beyond the normal trade terms, it would be very helpful to us. There are some industries where management is very truthful, there are other industries where managements lie. The movie business, the discount companies, the textiles are less truthful than the drug industry most of the time. The point is we think your responsibility is equal to us as investors as it is to the Board of directors that you're reporting to and you should know these industries very well. Put us on notice to ask the proper questions rather than treat the financial statements of a third rate retailer the same as you would for [name deleted]. [Also included in 17(a)] **[TI 10/16, p. 20]**

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 3(d)] **[TI 10/16, p. 23-24]**

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 1(c), 11(c), and 13] **[TI 10/16, p. 51-52]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Participant I-11
I'm going to make a radical statement. As audits are currently performed and reported, I think auditors do a very good job. If you define the audit assignment as what it is defined today, I think by and large the quality of audits is excellent. What most of us have been talking about in these sessions is less whether auditors are doing well what they're doing now, but whether there are other things they should be doing. [Also included in 17(a)] **[TI 3/17, p. 7]**

Committee/Staff/Observer
Our fourth question asks about expanding the auditors' role to audit information that is part of external reporting but that is not currently audited. As you know, the auditors' report currently covers the financial statements and the related notes. It does not cover other areas of external reporting. Our question is: would you find it useful if the auditor were to audit information in some or all of those other areas that are outside the scope of financial statements? And if so, which information? The meeting materials identified some unaudited areas for your consideration. **[TI 3/17, p. 9]**

Participant I-12
It could be very useful to take a look at other parts of reporting. The auditor's training is in accounting and it would be most appropriate to comment on any area in which management is disclosing numbers. As an example, a lot of financial companies have begun to disclose enormous amounts of information in a financial supplement, outside the purview of SEC reporting. They do that because that gives them the flexibility to present their businesses in the way that they look at them. That provides a sounder basis for analysts to communicate with management. Sometimes you wonder where those numbers came from and the underlying assumptions. Perhaps some review of those numbers periodically might be of use. **[TI 3/17, p. 9]**

Participant I-7
If we look at the MD&As, they're almost like a cookie-cutter. I'd like to see the auditor get involved when there are things that have taken place, in terms of material exposures or perhaps benefits to the organization, and that are not touched upon by management. I'd like to see the auditor infuse that information in the MD&A. **[TI 3/17, p. 10]**

Participant I-16
I have some reservations on the expertise level of the auditors. If anything, you want management to feel free to say more about their view of the company. I don't think the auditors should be expected to have mastered the nuances of the business to get involved in that; it's management's job. Having the auditor comment on such things as the adequacy of internal controls is very appropriate and could be helpful. **[TI 3/17, p. 10]**

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 2(b) and 9] **[TI 3/17, p. 10]**

Participant I-7
How much does the profession gets involved in setting standards for particular companies; for example, standards for quality of products, costs standards, etc? **[TI 3/17, p. 10]**

Committee/Staff/Observer
It largely depends on the client. **[TI 3/17, p. 10]**

Participant I-7
I feel that this is a key element, that is, the auditor getting involved in a program where estimates are made. **[TI 3/17, p. 11]**

Participant I-11
A central issue to these discussions is what the role of the auditor is or should be. I think that we may be looking at auditors to do more than they should be doing, using that as an excuse not to do it ourselves. The broad issue is that the financial statements of a company are supposed to accurately reflect the operating performance of that company. The proper role of the auditor is to provide independent judgement that the financial statements do provide an accurate reflection of the operating results. If you think of the role of the auditor in those terms, then expecting of the auditor to get involved in things like the MD&A or the company's forecasts are not appropriate functions for the auditor. On the other hand, issues relating to uncertainty of estimates are related to the auditor's role. To the extent that it is economically feasible, we ought to have a lot more information in that area. There is some limit based on cost-effectiveness. For example, I'm not sure that it is cost-effective to have a quarterly audit. [Also included in 9 and 17(d)] **[TI 3/17, p. 11]**

Participant I-12
I would agree with that. I know that a lot of companies that I cover have their statements audited not only quarterly but before they report, which I find astounding for companies who report 10 days after the end of the quarter. I don't see any need to have an audit done more than annually. I also think that there are areas where the auditor might become involved; measurement uncertainties, for example. Another area for auditors would be looking at transactions with related parties (including major suppliers and major customers). In close relationships like that, that's where a company has the greatest potential for trying to cook the books. An auditor could look at those transactions and determine whether they're being accounted for on an arm's length basis. [Also included in 9 and 17(d)] **[TI 3/17, p. 11-12]**

Committee/Staff/Observer
Should there be any auditor involvement with quarterly reports or once a year is enough? [Also included in 11(d) and 17(d)] **[TI 3/17, p. 12]**

Participant I-16
I think the quarterly issue has to be deferred towards the later discussion of what you want quarterly reports to be, in terms of whether they should be like annual reports, that is, discrete periods, or whether they should be an integral part of the whole year (thus, with some smoothing). You need to decide that before deciding whether they should be audited or not. [Also included in 11(d) and 17(d)] **[TI 3/17, p. 12]**

Participant I-7
Coming back to [committee/staff/observer]'s comment about companies in the same major industry having different auditors, it puts auditors at a great disadvantage when asked to express an opinion about management's forecasts compared to analysts following a specific industry and being able to look at the whole forest. Auditors don't have the sense of what's going on from a competitive point of view. I see no reason for the auditors to be involved with management's forecasts. [Also included in 12 and 17(c)] **[TI 3/17, p. 18]**

Committee/Staff/Observer
Let's suppose you have the financial statements of an institution that has a large portfolio of real estate loans. This group and others have told us that they would expect the auditor to evaluate management's assumptions about whether those real estate properties are going to be profitable or not, and to make judgements about whether the carrying values of the assets are appropriate or not, whether they should be reserved, and you expect the financial reporting to reflect the appropriate adjustments. How is that different from other kinds of projections? [Also included in 9 and 17(c)] **[TI 3/17, p. 18]**

Participant I-12
For real estate properties, there are current appraisals on most of these properties. Theoretically, banks and other financial institutions have set aside reserves to appropriately reduce the value of the assets to reflect the current situation. I don't know if real estate prices are going to go up or down; I will look at all of that and I'll make an estimate of my own. What I would like the accounting profession to do is to make it clear to me what the basis of all of that is. A question analysts ask a lot is: what percentage of original value have your

nonperforming real estate loans be written down? If we know how much has already been written down, we then have some information that will help us make estimates about how much more write-downs should be made given our general outlook. I would like to know what has already been done and what the status is. Managements are always making estimates; analysts try to know what the assumptions are and make their own estimates that can be radically different. I'm not sure the accounting profession needs to get involved in future estimates; the most important function of financial statements is clarity. [Also included in 9, 12, and 17(c)] **[TI 3/17, p. 19]**

Committee/Staff/Observer
The bulk of the MD&A compares the current and the previous period in narrative form. What's in that MD&A that troubles you with auditor involvement? **[TI 3/17, p. 20]**

Participant I-16
There is generally nothing in the MD&A that concerns me at all; it is generally a meaningless statement. Auditing it doesn't make any difference. [Also included in 13] **[TI 3/17, p. 20]**

Committee/Staff/Observer
Auditing doesn't make any sense because it's not useful, not because it's not within the purview of the auditors' role? **[TI 3/17, p. 20]**

Participant I-16
What you want to do is to make the MD&A more meaningful and to me it would be making it meaningful without auditing it. **[TI 3/17, p. 21]**

Participant I-11
The MD&A should be a discussion by management of the operating events that produce the financial statements. We all know that's not what it usually is. It's usually a regurgitation of the numbers. Similarly, the AD&A would be the auditors' discussion of the way the accounting principles and techniques were applied to the operating events to produce the financial statements. In that context, I think it's appropriate to have the auditors involved in estimates. For example, taking the real estate portfolio example, the balance sheet shows that on the balance sheet date there was an asset called real estate portfolio, and the value assigned to that asset was reached by making certain assumptions or estimates. In order to judge the accuracy of that figure, a user needs to have an idea of what those estimates were. As far as estimates in the future are concerned, I think [participant I-12] is right; that is what we're doing and I don't get any additional comfort by having an auditor tell me that management's estimates are good or bad because I'm making my own anyhow. A few years ago, when [name deleted] tried to do a big deal based on some projections of air travel that had factors and yields going nothing but up, that deal never got done because independent financial analysts said the assumptions were preposterous. [Also included in 12, 13, and 17(c)] **[TI 3/17, p. 21]**

Participant I-16
Perhaps there is a problem here with two different types of transactions. For manufacturing companies, we're dealing with transactions that occur in the future. Companies are going to

provide a service and be paid for it. While in many financial business, transactions occurred 5 years ago and what we're putting in the financial statements are the results of those past transactions. For example, insurance companies selling a policy where you're not going to find out for 5 years whether the person dies or not, or gets sick, or his house collapses. Or lend money to a hotel and you don't know whether the hotel is going to be able to service the debt. Maybe there are different types of transactions here, but most of the transactions we deal with outside of financial transactions are prospective transactions. A forecast does not relate to questions of what happened in the past. A forecast of how many of [name deleted] is going to sell next year, I don't think that the auditors' job, that's my job as a software analyst. But if I were doing a bank, I would have to know what is the status of the loans I made 5 years ago because that has a bigger impact on my reported earnings of 1993 than the loans I make in 1993. [Also included in 12 and 17(c)] **[TI 3/17, p. 21-22]**

Committee/Staff/Observer
[Participant I-11], you and others have observed that MD&As are often inadequate. I suspect that many auditors could write a good MD&A. Why would you not want the auditors to do that? [Also included in 17(c)] **[TI 3/17, p. 22]**

Participant I-11
I suspect that the auditors could write a better MD&A than those that are being written today. But I think that it is putting a responsibility on the auditor that he is really in principle ill-equiped to deal with. The MD&A should be a discussion of the operating events that transpired during the year. Management is being paid to cause those events to occur; so they're the logical people to tell us about it. [Also included in 17(c)] **[TI 3/17, p. 22]**

Participant I-12
And they're responsible to the shareholders. It seems to me that those who are responsible ought to be reporting back to the shareholders. The way the auditor is going to write an MD&A is going to be vastly different from the way management writes it. [Also included in 17(c)] **[TI 3/17, p. 22]**

Committee/Staff/Observer
Does that suggest that that be audited? You want to know bad enough to pay for it? [Also included in 17(c)] **[TI 3/17, p. 23]**

Participant I-7
Yes. For example, if you know that inflation is 3%, and management has decided to put a 0% increase for labor costs, I'd like an understanding of that. And that is within the auditors' role to give us comfort on that. [Also included in 17(c)] **[TI 3/17, p. 24]**

[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 auditor involvement.

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 2(d)] **[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 2(d)] **[TC 12/8, p. 43]**

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), 1(c), and 12] **[TC 12/8, p. 71-72]**

Participant C-4
I can't remember the last time I've seen a going concern opinion on a financial statement. I don't know how much forward looking work auditors are doing when they're doing their audit work, and then how much historic hindsight review they're doing when they're auditing of financial statements. It's not happening, particularly as I mentioned earlier, in the percentage of completion accounting. [Also included in 12 and 17(c)] **[TC 12/8, p. 74]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of auditor involvement.

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 4] **[TC 2/2, p. 4]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of disclosure on operating opportunities and risks. During the discussion, comments were made on auditor involvement.

Participant C-17
In financial statements today, what's being evaluated is really what the risks are. It's not so much the opportunities. But I certainly get a little uncomfortable when you start talking about getting together with the auditor to project opportunities. You know, I'm not sure that's what we should do. [Also included in 10(a)] **[TC 2/2, p. 29]**

Participant C-11
Talking about the specific examples in the meeting materials, some of them very good, where there could well be a near term quantifiable change occurring because of certain items. I think, ultimately, the preparer has a responsibility to understand and determine what those elements might be. An interesting subject here, is to what extent does the auditors also have responsibility to ascertain and know whether the management has properly identified quantifiable near-term things that could happen, that would have an impact on the various financial statements? [Also included in 10(b)] **[TC 2/2, p. 35]**

Participant C-4
There ought to be some specific identifiable questions that auditors should be able to come up with. What impact are some of these contingencies going to have on current cost? That ought to be the focus. Just like there are specific questions for extraordinary items that might come up. It's part of the audit process although we recognize that management is responsible for the financial statement. We also know in practice that the smaller the company, really the CPA's more responsible for financial statements than management itself. **[TC 2/2, p. 35]**

[Context] Meeting of the Creditor Discussion Group on February 2, 1993. Part of the meeting was devoted to the topic of disclosure about measurement uncertainties. During the discussion, a comment was made on auditor involvement.

Committee/Staff/Observer
I understand that one type of disclosure would be boilerplate, the acknowledgment that it's inherently risky. The second type of disclosure could deal with how much do you want to

know about these estimates. If we go to page 24, it proposes that there could be a variety of approaches to telling users more about things that underlie assumptions. Sometimes it could be something as simple as the aging of accounts receivable to show a little bit more about how the bad debt reserve might relate to it. In other cases, it might be much more complicated to talk about, for example, warranty experience and quality controls inherent in manufacturing process, and some other fairly in-depth discussions. Is this useful information? Is the financial report the correct place to put it? What is your feeling as a user, if that is what you want? How do you deal with it? How would you expect the package to look to make it useful? [Also included in 9] **[TC 2/2, p. 50]**

Participant C-5
I don't know if I would have an auditor provide that. [Also included in 9] **[TC 2/2, p. 50]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Committee/Staff/Observer
Let me pursue this off balance sheet topic that some of you have raised. There is off balance sheet disclosure now. I'd like to have a better feel in terms of what you view the auditor relationship with that off balance sheet information as it exists now is. Do you see that as either ill-defined, well-defined, or needs redefining? [Also included in 19] **[TC 3/11, p. 5]**

Participant C-11
The off balance sheet disclosure that we now have just recently been getting is not useful to me. It's just a bunch of big numbers and it doesn't get into the qualitative aspects of the risks. But addressing the question you're speaking of, I was not necessarily speaking of off balance sheet items versus on balance sheet items. I was thinking of critical areas where, in the case of financial institutions, a massive number of individual transactions take place, and those can be audited on an on-the-spot basis. What is more critical to me is that the whole process of whatever those transactions are, be analyzed as a process, in terms of whether the right data is captured. For instance, are there really hedging transactions being captured or are there a combination of hedging and speculation? So, it's not the individual transaction I'm thinking of. It's the whole process or business that's being undertaken, and whether the proper information is coming in an aggregate form in the right way. And whether the systems involved do capture things properly. And that could be on and off balance sheet. [Also included in 19] **[TC 3/11, p. 5]**

Participant C-12
I think maybe off balance sheet is a whole separate discussion. What we're getting now is minimal information of substantial exposures. And we're getting no explanation of what's involved in these exposures. What the financial risk is, what the credit risk is, how it breaks down. But I think that's a separate topic altogether. [Also included in 19] **[TC 3/11, p. 6]**

Participant C-5
I would agree that current disclosure doesn't give us a view of what the risks are. I will also confess in regular conversations with peer institutions on the very subject that, as we measure our risk to each other, everyone has a slightly different approach. The basic approach is similar, but the numbers all come out differently based on how we quantify risk. We are all moving increasingly towards some commonality in that area, but the idea that you would give an opinion and say that what's been presented is a fair representation, without allowing me to know the differences and have the raw data to make a determination of my own, is troubling. I know my aggregate positions with any other counterpart but I have no concept of their aggregate exposure. And the raw information which is provided is clearly insufficient to make some determinations or risk calculations. Whether it's something as complicated as options, forwards, and swaps, or something as simple as purchased intangibles, like servicing rights. Just in the last year, the dynamics of that market have been so significant that we have been throwing credits out of our committee because our own people don't even know the detail behind the numbers. And we have difficulty getting them. Management can't provide them. If they can't provide them to us as a negotiating creditor, I doubt the auditors have been able to get that kind of information, or really have reviewed it in the right kind of depth. [Also included in 19] **[TC 3/11, p. 6]**

Participant C-13
There are two issues here. I agree with everything that has been said about disclosure and availability of information for off balance sheet items and liabilities and assets and contingent liabilities. But the other issue is the audit and control issues concerning those items. And I think everything that you've heard in the last three minutes suggests that there's a concern, a serious concern, about the controls that exist. There have been numerous instances of surprises or failure of controls among very large companies. That would suggest that the users are very interested in the audit functions of these off balance sheet items. [Also included in 19] **[TC 3/11, p. 6-7]**

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 2(d) and 19] **[TC 3/11, p. 7]**

Participant C-5
The role of the auditors of our bank has shifted to much more forecasting, reviewing our forecast, our projections, and so forth. They also opined on our reserves quarterly. My value in the auditors is to understand where we think we're going, and to issue financial statements that allow the user to having that same understanding, to decide for themselves. If you've got a concern about Texas real estate and the thrift is in Texas, I would like to know how much of the real estate is in Texas, as opposed to maybe up in Colorado or in Pennsylvania. And so

the presentation of financial statements needs to be designed that way. The supplemental financial information would need to be designed in a way that the user could make their own determinations about the projections, forecasts, the future direction of the company. What I found, however, is in going forward, as auditors have had to put opinions on projections, they've applied a conservative bias. As creditors, we create a best case, which is our sort of operating assumption, very different from what management projects itself -- their management case. We then have a worse case. We've got three case scenarios. I don't need the auditor to give me the worst case. I need to know the legitimate case. And actually I struggle at times, because I really almost don't want their opinion; I want them to give me an update so that I can have my own opinion. And I don't get that out of the financial statements. The conservative bias has created a philosophy around our bank to lend on forecasting that's not the most accurate forecast or the best estimate, but the most conservative estimate of a forecast. That's not what creditors really need. They'll do that themselves. [Also included in 17(a)] **[TC 3/11, p. 8-9]**

Participant C-11
Just to clarify my remark. I was not speaking of the accounting profession giving her blessing on forecasts. I was thinking in terms of doing their own work -- when they do they own work and have to address the going concern question -- what they have to do in their own internal analysis. They have to address those issues and have to come to decent conclusions. I wasn't thinking of public forecasting. **[TC 3/11, p. 9]**

Participant C-15
Is it really the role of the auditors, or should they present you the information in such a way that you can do the analysis? I don't think we can ask the auditors to interpret and analyze all that information. The role of the auditors should be to present the information in a clear and consistent way. As we're discussing disclosure and so on, clearly there are improvements that could be made in disclosure. And the information should be there for the analyst or the user of financial information to reach his own conclusions. But the auditor shouldn't reach those conclusions for the user. **[TC 3/11, p. 9]**

Participant C-14
I agree with that because I think it would even put more pressure and cloud the objectivity of the auditors. You have to have a base of some kind, to not only judge the accuracy of the information, but then state an opinion on it. I think the kinds of things they could do is more focus on validating , for example, asset values. It is an area that has been a disappointment. When a company comes out and does an inventory or asset write down, the first thing that goes through your mind is: "Well, where were the auditors in validating the presented numbers on the balance sheet on this?" [Also included in 17(a)] **[TC 3/11, p. 10]**

Committee/Staff/Observer
Are you saying that auditors aren't asking the reasonableness question? Or are not asking it enough? Or asking it correctly? [Also included in 17(a)] **[TC 3/11, p. 10]**

Participant C-14
I'm basing my opinions on empirical evidence. I'm not saying that what you do isn't right, but I'm saying that it's not working, because we see companies -- [names deleted] -- doing

their every year restructuring and write-downs. If the auditors aren't onto [name deleted] by now, you know, they're missing something. So I'm sure that the work is appropriate and it's adequate, in terms of validating that the procedures that [name deleted] uses to account for its asset values are GAAP. But then I think the auditors have to step back and say: "Does that number look right?" Based on the profitability relative to other people in the industry, are those asset values they're carrying in line with the cash flow earnings they're generating? And I would say that holds for inventories as well. [Also included in 17(a)] **[TC 3/11, p. 10]**

Participant C-13
I'm having a little difficulty with some part of this conversation because it doesn't seem to me that it's the role of the auditor to set disclosure standards, or determine accounting policies. Those jobs are for standard setters and regulators. And what the institutional investor wants from the auditor is a sense of assurance in the reliability and accuracy of what's presented, rather than asking them to define what disclosures ought to be. **[TC 3/11, p. 10-11]**

Committee/Staff/Observer
From the perspective of an auditor, I'm not sure what I'm hearing. Is it the role of the auditor to provide reliable, factual information, that you make the assessment about? Or are you saying that the auditor should go beyond that and make judgments about value and whether those assets are collectible, preservable? I thought [participant C-11] was suggesting that the auditor is expected to go beyond reporting on the factual information, to make assessments about future prospects. I'm not sure that that's what I'm hearing from this end of the table. This is a bit confusing, and has been for a long, long time, as to what really is expected from the auditor's report on the financial statements. **[TC 3/11, p. 11]**

Participant C-5
For example, if [name deleted] has a one-time write-down because of a change in the strategy. Now the issue is: should the auditors have foreseen that the first strategy was not going to be successful and therefore taken a more conservative view? **[TC 3/11, p. 11]**

Committee/Staff/Observer
Or was that the user's responsibility based on the information provided? **[TC 3/11, p. 11]**

Participant C-5
This user did it, but I don't know about others. I'm not distressed in the case of Westinghouse, because I do believe at that point, given the strategy that was understood, that it was possible there was also a significant period of deterioration. I'm not so sure that that is a problem. I don't mind auditors making assumptions but I need all the details that went into that assumption. Because your biases are different than mine, I have to make my own opinion. It's my money at risk, not yours. I just need to know that what I'm seeing is good raw data, independently observed and factually correct. [Also included in 17(c)] **[TC 3/11, p. 12]**

Participant C-1
Yes but I think that's the real issue: is the data really independently observed? And from my standpoint, in terms of work-outs, I can tell you that I don't think it is. If you have accountants who are doing audits for minuscule amounts of money, or zero profit, who are

then coming in and doing consulting work, work-out work, executive comp work, how can that possibly be independent? Also, the quality of audit is so varied. And the quality of the people doing the audits is so varied. In some cases, the way they audited the inventories or the receivable is wrong, or it's not accurate, or they haven't spent enough time. [Also included in 17(a)] **[TC 3/11, p. 12]**

Committee/Staff/Observer
When you say the inventory was wrong, do you mean that it wasn't there, or that the cost of it was incorrect? Or do you mean that the company couldn't get the value that's on the balance sheet in a fire sale? [Also included in 17(a)] **[TC 3/11, p. 12]**

Participant C-1
We have, in retailing especially, a continuous change in strategy. And auditors seem to ignore the fact that inventory that has been there for three years is not going to be sold. And the cost is not a good price. And it doesn't get written down. It's a value question, and it's a question that if it's not getting sold, why is it still there as a current asset? [Also included in 17(a)] **[TC 3/11, p. 12]**

Participant C-4
I see a real problem with inventory and receivables consistently being carried as current assets when they are never realized in the current cycle. I think the hindsight review is inadequate in a lot of areas and on those items in particular. [Also included in 17(a)] **[TC 3/11, p. 13]**

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 5(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 5(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 5(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 5(b)] **[TC 3/11, p. 15]**

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 5(b) and 17(a)] **[TC 3/11, p. 17]**

Committee/Staff/Observer
Question number 4. Would it be useful if the auditor were to audit information that is outside the financial statements, and provide some kind of assurance? If so, please help us understand what is it you might choose between a) and f) in the meeting materials and why would it be helpful to you? **[TC 3/11, p. 21]**

Participant C-5
I have mentioned that we actually have had quarterly representations as to the adequacy of our reserve. That was something that our management made a decision two years ago now because of the concerns. As to my personal view on this, I assume that whenever I read an annual report the auditor should have some opinion about the supplemental disclosures that are in there. I know that there's a lot of disclaimers about that work. Although I do know in our own internal situation, they do extensive review, and I don't know how many times we've had to modify schedules because of adjustments that the auditors have made. I feel there's a sense of accountability throughout, even though there's disclaimers about it already, and I would like to see it just broadened to include those additional disclosures of factual information, whether it be concentration schedules that we prepare typically, or maturity schedules, or valuation schedules, or mark to market on certain historical cost items. **[TC 3/11, p. 21-22]**

Participant C-17
There's an underlying theme here, and it divides itself into two parts. The first question that keep coming up is basically: what more can the auditor do? How can he expand his role in order to meet users' needs? And the second part of it is doing what he already does, but doing it better. If I had to make a choice, because of cost reasons and because of the desire to maintain independence, it's basically doing what you do, but giving a greater assurance of what we see is what we think it is. **[TC 3/11, p. 22]**

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 1(b) and 13] **[TC 3/11, p. 22]**

Participant C-10
Yes, I like that. I also would vote in favor of as much as you could do quarterly. Again, I think that depends on the size of the companies and costs. [Also included in 17(d)] **[TC 3/11, p. 22]**

Participant C-15
[Participant C-12], do you think that you would get as much information out of the MD&A section if it was audited as if it wasn't audited? Some of the discussion is real helpful; do you think that might be sort of reduced if the auditors had to sign off on that? [Also included in 13] **[TC 3/11, p. 23]**

Participant C-12
Possibly, although the SEC has mandated a lot of that as well. **[TC 3/11, p. 23]**

Participant C-15
I think that it would be very helpful to have the numbers, if you will, the factual information audited. In terms of the soft type information, it would be difficult for auditors to sign off on

that, and I think that it would just be eliminated from the discussion. The "D" part of the MD&A would be shortened. **[TC 3/11, p. 23]**

Participant C-13
You already had to run it through the legal department. If you have to run it through the auditors as well, it will be even less meaningful. **[TC 3/11, p. 23]**

Committee/Staff/Observer
So you see it the same way [participant C-15] does? **[TC 3/11, p. 23]**

Participant C-13
Yes. **[TC 3/11, p. 23]**

Participant C-5
I believe that the fact that those areas are not opined on is a risk mitigant for the auditor as opposed to a need for scope expansion. Quite frankly, the detail auditors get into in other stuff is no more severe than what they get into on the supplement and the MD&A type disclosures. It's just that whatever you can do to reduce that liability factor is the driver behind not making affirmative statements. Obviously as you move down the scale in the quality of the audit firm, some smaller and medium sized firms will clearly just disregard those sections and make their disclaimers and don't treat it. But in a Fortune 500 type company, I find it very difficult to believe that auditors don't take a sense of ownership and accountability, and probably charge for scope work associated with review of that activity, regardless of the opinion that's issued or the disclaimers. I also want to touch on section (e) in the meeting materials. For mid-size companies, I basically get a consolidated statement (holding company and operating subsidiary) without the detail as to operating subsidiary reporting and so forth. The only thing I guess that could get me over that without having to do a report on the individual operating company itself is to clarify the intercompany transactions which are awash in consolidated reporting. That at least would give me a better comfort level as to the integrity of the operating company financial statements, if I can at least eliminate some of the intercompany and the non-external transactions, and understand the depth of those and sort of the issues between them. [Also included in 18(b)] **[TC 3/11, p. 23-24]**

Participant C-1
I would hate to lose the information and the facts that are in the MD&A because they all of a sudden have to be audited. For example, discussion of the estimated impact of a strike or a plant closure that wouldn't necessarily be broken out in the normal financial statements. While I think it would be great if auditors looked at that, I'd hate to lose it because it is such an important way that we look at companies. [Also included in 13] **[TC 3/11, p. 24]**

Committee/Staff/Observer
Is it your impression that the auditors now do not look at the MD&A's? [Also included in 13] **[TC 3/11, p. 24]**

Participant C-1
No, it's my impression on talking to companies that they will put stuff in the MD&A that, if you read it carefully, will answer your question in terms of one-time charges, that can not be broken down in the financial statements. [Also included in 13] **[TC 3/11, p. 24]**

Committee/Staff/Observer
Same difference. How much do you think auditors presently do today with regard to the MD&As? **[TC 3/11, p. 24]**

Participant C-1
I guess I don't think they do that much. **[TC 3/11, p. 25]**

Participant C-5
I know they do. At least on the large companies. **[TC 3/11, p. 25]**

Committee/Staff/Observer
The problem is they don't tell you what they do. [Also included in 17(c)] **[TC 3/11, p. 25]**

Participant C-11
I know that they have always been told by the companies that the auditors review the MD&A type information. I think that's excellent. I would be nervous about making it a formal requirement, and I don't think accountants should in effect write the MD&A. I want to know about the company's business strategy; I'd hate to lose that information. [Also included in 13] **[TC 3/11, p. 25]**

Participant C-10
You earlier asked me if I agreed with the point about extending the audit to the MD&A. I would just say that I really like the MD&A. We all use it. The question is how do we keep it as valuable as it is, and if anything, have the auditors help increase that value. But at the same time not put limitations on it. [Also included in 13] **[TC 3/11, p. 25]**

Committee/Staff/Observer
Would you want an MD&A for private and smaller companies? [Also included in 2(d) and 13] **[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 2(d) and 13] **[TC 3/11, p. 25]**

Participant C-4
We're hitting at what the role of the auditor is. And if we're asking the auditor to make assessments about what the business risks are, I think that's really beyond the scope of what we want. I would be more interested in the auditor disclosing at what level they've audited

from a materiality standpoint, and what has taken place from a statistics standpoint. What were the basis for their estimates for doubtful accounts? And on a hindsight basis, how do these current estimates compared to the prior year results? So some format of factual presentation as opposed to their doing the assessment. We'll do the assessment but we would like more information about how estimates were arrived at. [Also included in 9 and 17(c)] **[TC 3/11, p. 33]**

Participant C-14
Couldn't somebody read the generally accepted audit standards guides and more or less get that information? I don't see where that provides any value. On the one hand, we spent the first half of this morning telling you that we want you to use more judgment in how you look at the quality of the numbers. And then on the other hand, everybody's saying well no, don't say anything that's not standard. I don't think we can have improvement in the quality of the auditing of the information and the assurances it gives without giving you more latitude to be professionals and make judgments and give you some wherewithal to express yourselves. In terms of independence, the degree of standardization in the letter does help maintain your independence; if every letter has certain components but some flexibility within that, then it gives you what you need to be independent and objective but also be critical. [Also included in 17(c)] **[TC 3/11, p. 33]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 5

Would you find it useful if the auditor were to *audit* information in some or all of those other areas that are outside the scope of annual financial statements?

YES *4*
NO *1*

Participant I-9: Do not try to expand the bounds of your profession! It will only get you in difficulty. The fees aren't worth it!

If YES, which of the following information should be *audited*? The following examples are items found in public reports; however, your response does not need to be limited to topics currently part of regulatory reporting for public companies. (Please check *all* that apply.)

	Applica ble
a. Quarterly financial information	*4*
b. Financial forecasts or projections, if presented	

c. Management's comments about the company's recent operations, such as in (1) management's discussion and analysis of operations, (2) the president's letter, (3) management's report on the company's system of internal control, if presented, (4) management's report on the company's compliance with laws and regulations, if presented, and (5) the discussion of legal proceedings in the 10-K	*2*
d. Discussion of the company's business, such as (1) the description of the business in the 10-K, and (2) listing of properties in the 10-K	1
e. Summary of the company's transactions and relationships with certain related parties, such as in (1) the security ownership of certain beneficial owners and management section in the 10-K, (2) certain relationships and related party transactions section in the 10-K, (3) discussion of compensation plans in the proxy statement, and (4) section on compensation of directors and officers in the proxy statement	*4*
f. Some other section of the annual report, 10-K, proxy statement, or registration statement. If so, which section?	

[PMQI 3/17, p. 8-9]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 5

Would you find it useful if the auditor were to *audit* information in some or all of those other areas that are outside the scope of financial statements?

_6_ YES _7_ NO

Participant C-4: This is the analysts job or other qualified experts.

If YES, which of the following information should be *audited*? The following examples are items found in public reports, however, your response does not need to be limited to topics currently part of regulatory reporting for public companies. (Please check *all* that apply.)

_2_ a. Quarterly financial information

_3_ b. Financial forecasts or projections, if presented

_5_ c. Management's comments about the company's recent operations, such as in (1) management's discussion and analysis of operations, (2) the president's letter, (3) management's report on the company's system of internal control, if presented, (4) management's report on the company's compliance with laws and regulations, if presented, and (5) the discussion of legal proceedings in the 10-K

Participant C-12: "No" on president's letter, "neutral" on the discussion of legal proceedings in the 10-K.

_0_ d. Discussion of the company's business, such as (1) the description of the business in the 10-K, and (2) listing of properties in the 10-K

_5_ e. Summary of the company's transactions and relationships with certain related parties, such as in (1) the security ownership of certain beneficial owners and management section in the 10-K, (2) certain relationships and related party transactions section in the 10-K, (3) discussion of compensation plans in the proxy statement, and (4) section on compensation of directors and officers in the proxy statement

_1_ f. Some other section of the annual report, 10-K, proxy statement, or registration statement. If so, which section?

Participant C-11: Let's get the auditor to do a better job on the annual audits themselves. See comment after 4a.

Participant C-17: B - Auditors' should review and disclose the base assumptions which drive the projections, they need not opine on the "reasonableness" or probability of achievement.
[PMQC 3/11, p. 7-8]

17(c). Audit Reports

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Participant I-16
One of the things that bothers me is the auditors' current position of either saying "good housekeeping-seal of approval" or "there's something that bothers me here". I presume that in looking at a lot of different clients, the auditors get some idea of where there are choices to be made, either in terms of what principles you chose to apply, or the types of conservatism embodied in estimates. It would be very helpful if auditors could give us some sense, on a qualitative basis, for all companies, at least in broad bands, of how a company's practices compare against its peer companies. It would be better than to say that 99.9% of companies are O.K. and nothing more is said other than this packaged audit statement. [Also included in 17(a)] **[TI 3/17, p. 5]**

Participant I-7
We have discussed in previous meetings that in going through your procedures, estimates were made so that not everything is specific to the dollar. Estimates are made in your audit procedures that are of such significance that, if a different route had been chosen, there may have been a material change in the end result. We'd like to know about that. [Also included in 17(a) and 9] **[TI 3/17, p. 5]**

Participant I-12
I'm not even sure that that's the arena of the auditors [to detect and report the potential effects of major changes in environments]. I harked back to the change in tax law in 1986 which had enormous implications on the future of real estate partnerships. One would think that perhaps such things should be given more prominence in the financial statements or audit reports. Things of that nature should somehow be highlighted. [Also included in 9 and 17(a)] **[TI 3/17, p. 5-6]**

Committee/Staff/Observer
It sounds like what you and [participant I-16] are saying is the same. Our audit report now is kind of a one-size-fits-all report, very standardized. But the world is becoming more and more subjective, decisions have to be made more rapidly, and the impact on longer term assets is more and more uncertain; so it would be useful if the audit report could reflect that environment. [Also included in 9 and 17(a)] **[TI 3/17, p. 6]**

Participant I-16
When I first became a financial analyst 20 years ago, the major concern one had was the choice of accounting principles of management and how they could affect the numbers. Over the last 5 years, we know that what's really important are the estimates. When you see the enormous write-offs that companies have made in the last few years, they're basically saying that for years they have overstated their earnings by making bad estimates. Yet, auditors have not acknowledged that problem in their report. They also do not acknowledge when a

company, every year for 5 straight years, has a huge write-off of assets in the fourth quarter, which says that they have been misleading people for eternity by capitalizing expenses. [Also included in 9 and 17(a)] **[TI 3/17, p. 6-7]**

Committee/Staff/Observer
Question 5 deals with the form of the auditors' report. Professional standards currently require highly standardized audit reports of financial statements. We have very little flexibility to customize reports. Thus, audit reports are the same from company to company. As an alternative to standardized reports, they could be more tailored to the specific company and circumstances. The meeting materials offered three examples of customized reporting:
1. The report would discuss in more detail the specific scope of the auditors' work.
2. The report would discuss in more detail the specific results of the work performed.
3. The third example would offer some qualitative evaluation of a company's reporting in addition to the opinion about whether the financial statements are fairly presented.

Our question is: should audit reports remain highly standardized, or should they be more tailored to the specific company and circumstances? **[TI 3/17, p. 12]**

Participant I-12
We do need a standard of audit report that we can rely upon. But there should be no reason why an auditor could not add additional commentary. The audit report has become boilerplate in some respects. Auditors have a viewpoint and can offer us insights that could be of use, and I don't think that they should be discouraged from doing that. It should be communicated to us, somehow, that just because an auditor says something a little different from boilerplate, that that doesn't necessarily mean that what he is saying is bad. We need to allow auditors more flexibility to use their expertise and make some comments of use to us. **[TI 3/17, p. 12-13]**

Participant I-16
I agree on that point. The auditor in doing his work comes up with a lot of information that should be of interest to the owners of the business. The only way to communicate that is not to tell management but to tell it in the audit report so that the owners get the full flavor of what the auditor has learned through his analysis of the company's reporting. The types of comments that could be made include: general comments on the historical reliability of the company's estimates, its reporting practices versus peer companies in the same businesses, and how material this is to what is reported. **[TI 3/17, p. 13]**

Participant I-7
Item c (in the meeting materials) says it best to me. **[TI 3/17, p. 13]**

Committee/Staff/Observer
[Which is] offer qualitative evaluation of a company's reporting. What does it mean to you? **[TI 3/17, p. 13]**

Participant I-7
I'm not sure whether I can ask an auditor to measure one company's reporting against another. In the course of an audit, the auditor comes across certain paths in which estimates and

assumptions are made; if those estimates and assumptions are continuously made in favor of the company and they are material relative to the bottom line, I'd like to know that on a qualitative basis. [Also included in 9] **[TI 3/17, p. 13]**

Committee/Staff/Observer
How would you deal with the fact that auditors very often cannot deal with competitors? So in major industries, each company is audited by a different auditor. How do you get a meaningful comparison of a peer group by the auditor? [Also included in 9] **[TI 3/17, p. 13]**

Participant I-7
It would be extremely difficult to ask the auditor to know what's going on elsewhere in the industry. But in the course of the audit, you know that certain assumptions and estimates are made, and you know enough about the particular business that making different estimates would have a material effect; that could be disclosed. [Also included in 9] **[TI 3/17, p. 14]**

Participant I-12
I would be particularly interested in the management control systems and the management information systems. The businesses that I cover are highly qualitative and it's very difficult for me to make any assessments of those systems, except over a rather lengthy period of time. Coming back to the example on real estate partnerships, I think an auditor can fairly say that this particular business has x% of revenues exposed to real estate partnerships, and there has been a recent change in tax laws which may change that. Sometimes, it may have a massive impact on the bottom line. That kind of information would be of use. **[TI 3/17, p. 14]**

Committee/Staff/Observer
[Participant I-12], when you say management control systems, do you mean systems used to prepare financial statements or systems that help management manage the company, or both? **[TI 3/17, p. 14]**

Participant I-12
Both. I cover financial companies. There are lots of financial control systems, for example the hedging system, asset and liability management systems; these are critical systems for these companies to run their businesses. It's very difficult for an analyst to know what they're doing; are they controlling the business, do they have open positions or are they speculating? From the existing information we have, we don't know. Some assessment of those control systems, the amount of latitude that it leaves management to engage in speculation in financial markets, would be useful. Maybe I'm asking too much but this is the heart and soul of the businesses that I cover. It's very difficult from the outside to make any assessment of it. Auditors would run across those systems a great deal during the course of their work and they could give us some input. Any business that does hedging nowadays has to have some financial control systems to keep order. [Also included in 19] **[TI 3/17, p. 14]**

Committee/Staff/Observer
Question 6 deals with expanding the auditors' role, not his report, but what he is doing. In current practice, auditors audit management representations in the financial statements, and offer their opinion about whether those representations fairly present what they purport to present. Generally, the auditors make no representations themselves, other than the three

paragraph opinion on the financial statements. Alternatively, the auditor could do more. In addition to offering an opinion on management's representations, the auditor could report their own representations, perhaps through analysis and commentary, based on their audit work. The auditor could analyze and comment on a number of topics such as key estimates used in preparing the financial statements, risks and uncertainties facing the company, trends and changes in the financial statements, the quality of the company's system of internal control, and others. Our question is: would you find it useful in your work if the auditors expanded their reporting to include the auditors' analysis and commentary, in addition to their opinion on the management's financial statements? If so, what should be included? **[TI 3/17, p. 15]**

Participant I-11
I would find it very useful and some of the things we were talking about in the prior question would belong in this sort of "AD&A", and all of the above should be included. It would be a vehicle wherein the auditor could express its qualitative judgements about where, within the spectrum of GAAP, this particular client's practices lay, what level of confidence the auditor has in the financial control systems, etc. The only thing I'm concerned about is that the AD&A would become the same sort of meaningless boilerplate that the MD&A is so often. But I think it's a good idea. That might lead to a fourth normal paragraph in the standard audit report with some statement about the AD&A. **[TI 3/17, p. 15]**

Participant I-12
It would be very helpful to learn about all those things, to get some viewpoint from someone who sees things far more closely than we do; the management information systems, management's assumptions, range of accounting principles that they are using. All of those things would be extremely useful. [Also included in 9] **[TI 3/17, p. 15]**

Committee/Staff/Observer
Where does financial reporting end and financial analysis begin? [Also included in 1(d)] **[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 1(d) and 9] **[TI 3/17, p. 16]**

Committee/Staff/Observer
Given that the kind of information that you are talking about would be important to you, would it make a difference whether that information is included as part of the auditors' report or AD&A as compared to being included in a note to the financial statements? **[TI 3/17, p. 16]**

Participant I-7
It would have a greater impact in an AD&A. **[TI 3/17, p. 16]**

Participant I-12
I agree with that. **[TI 3/17, p. 16]**

Participant I-11
Yes. **[TI 3/17, p. 16]**

Committee/Staff/Observer
[W]ould you find projections of future performance prepared by management and audited to be of value? [Also included in 12] **[TI 3/17, p. 17]**

Participant I-12
No. [Also included in 12] **[TI 3/17, p. 17]**

Participant I-16
Yes. I don't see why that has to be audited, but I think that is something that management should be encouraged to do. If I own 100% of a business and I had somebody running it, I would ask to see his plans for the coming year. I understand that for a company with 1 million shareholders, you're not going to put out that kind of detail. But giving some indication of what you anticipate being able to accomplish in the future, the obstacles that you have to overcome, and the opportunities that you pursue, I think management should be encouraged to provide broad guidelines on that. And I don't think they should be encumbered by the auditors in that regard. I think that's between management and shareholders and I don't think the auditor has a role in that. If the auditor did have a role, it would dampen the explicitiveness of what management is saying; you don't want boilerplate, you want something that is meaningful. [Also included in 10(c) and 12] **[TI 3/17, p. 17]**

Participant I-7
Coming back to [committee/staff/observer] comment about companies in the same major industry having different auditors, it puts auditors at a great disadvantage when asked to express an opinion about management's forecasts compared to analysts following a specific industry and being able to look at the whole forest. Auditors don't have the sense of what's going on from a competitive point of view. I see no reason for the auditors to be involved with management's forecasts. [Also included in 12 and 17(b)] **[TI 3/17, p. 18]**

Committee/Staff/Observer
I'd like to challenge that. Management makes a projection which is based upon estimates and assumptions. You said you want us to be involved in historical financial statements, in either expanding in a note or in an AD&A, by having standards to disclose more about measurement uncertainties. Those same uncertainties enter into a projection. As a starting point, couldn't the auditor be properly involved in a projection by expressing an opinion about whether management's assumptions are realistic (based on x dollars, x volume, x units)? [Also included in 9 and 12] **[TI 3/17, p. 18]**

Participant I-12
That's our business, that's what we do. There's no need for us if the auditor is going to do it. [Also included in 9 and 12] **[TI 3/17, p. 18]**

Committee/Staff/Observer
Let's suppose you have the financial statements of an institution that has a large portfolio of real estate loans. This group and others have told us that they would expect the auditor to evaluate management's assumptions about whether those real estate properties are going to be profitable or not, and to make judgements about whether the carrying values of the assets are appropriate or not, whether they should be reserved, and you expect the financial reporting to reflect the appropriate adjustments. How is that different from other kinds of projections? [Also included in 9 and 17(b)] **[TI 3/17, p. 18]**

Participant I-12
For real estate properties, there are current appraisals on most of these properties. Theoretically, banks and other financial institutions have set aside reserves to appropriately reduce the value of the assets to reflect the current situation. I don't know if real estate prices are going to go up or down; I will look at all of that and I'll make an estimate of my own. What I would like the accounting profession to do is to make it clear to me what the basis of all of that is. A question analysts ask a lot is: what percentage of original value have your nonperforming real estate loans be written down? If we know how much has already been written down, we then have some information that will help us make estimates about how much more write-downs should be made given our general outlook. I would like to know what has already been done and what the status is. Managements are always making estimates; analysts try to know what the assumptions are and make their own estimates that can be radically different. I'm not sure the accounting profession needs to get involved in future estimates; the most important function of financial statements is clarity. [Also included in 9, 12, and 17(b)] **[TI 3/17, p. 19]**

Committee/Staff/Observer
A question on the concept of AD&A. The words that were used were discussion of estimates, principles, and controls. But AD&A sounds a lot like MD&A, and MD&A deals with discussion of the results of operations for the period. Did any of you who used the word AD&A mean to suggest discussion of the results of operations in addition to the three other items? **[TI 3/17, p. 19]**

Participant I-11
I did not. **[TI 3/17, p. 19]**

Participant I-12
I agree. **[TI 3/17, p. 19]**

Participant I-16
I wouldn't have used the word AD&A. **[TI 3/17, p. 19]**

Committee/Staff/Observer
Whether you call it something different or not, would you encompass an analysis of operations? **[TI 3/17, p. 20]**

Participant I-16
No. I think the 3 things that [committee/staff/observer] mentioned (estimates, principles, and controls) are the purview of the auditor. **[TI 3/17, p. 20]**

Committee/Staff/Observer
Is that because that information will allow you to better assess the quality of earnings and would not be the auditor's assessment of the quality of reported earnings? **[TI 3/17, p. 20]**

Participant I-16
Yes. Clearly it would be if the auditors would say these are the numbers that report the company's past, how they were compiled, how reliable they are, how sensitive they might be to change in estimates, how sensitive they might be to change in the accounting principles chosen, and are the controls adequate so that management knows what's going on. **[TI 3/17, p. 20]**

Participant I-11
The MD&A should be a discussion by management of the operating events that produce the financial statements. We all know that's not what it usually is. It's usually a regurgitation of the numbers. Similarly, the AD&A would be the auditors' discussion of the way the accounting principles and techniques were applied to the operating events to produce the financial statements. In that context, I think it's appropriate to have the auditors involved in estimates. For example, taking the real estate portfolio example, the balance sheet shows that on the balance sheet date there was an asset called real estate portfolio, and the value assigned to that asset was reached by making certain assumptions or estimates. In order to judge the accuracy of that figure, a user needs to have an idea of what those estimates were. As far as estimates in the future are concerned, I think [participant I-12] is right; that is what we're doing and I don't get any additional comfort by having an auditor tell me that management's estimates are good or bad because I'm making my own anyhow. A few years ago, when [name deleted] tried to do a big deal based on some projections of air travel that had factors and yields going nothing but up, that deal never got done because independent financial analysts said the assumptions were preposterous. [Also included in 12, 13, and 17(b)] **[TI 3/17, p. 21]**

Participant I-16
Perhaps there is a problem here with two different types of transactions. For manufacturing companies, we're dealing with transactions that occur in the future. Companies are going to provide a service and be paid for it. While in many financial business, transactions occurred 5 years ago and what we're putting in the financial statements are the results of those past transactions. For example, insurance companies selling a policy where you're not going to find out for 5 years whether the person dies or not, or gets sick, or his house collapses. Or lend money to a hotel and you don't know whether the hotel is going to be able to service the debt. Maybe there are different types of transactions here, but most of the transactions we deal with outside of financial transactions are prospective transactions. A forecast does not

relate to questions of what happened in the past. A forecast of how many of [name deleted] is going to sell next year, I don't think that the auditors' job, that's my job as a software analyst. But if I were doing a bank, I would have to know what is the status of the loans I made 5 years ago because that has a bigger impact on my reported earnings of 1993 than the loans I make in 1993. [Also included in 12 and 17(b)] **[TI 3/17, p. 21-22]**

Committee/Staff/Observer
[Participant I-11], you and others have observed that MD&As are often inadequate. I suspect that many auditors could write a good MD&A. Why would you not want the auditors to do that? [Also included in 17(b)] **[TI 3/17, p. 22]**

Participant I-11
I suspect that the auditors could write a better MD&A than those that are being written today. But I think that it is putting a responsibility on the auditor that he is really in principle ill-equiped to deal with. The MD&A should be a discussion of the operating events that transpired during the year. Management is being paid to cause those events to occur; so they're the logical people to tell us about it. [Also included in 17(b)] **[TI 3/17, p. 22]**

Participant I-12
And they're responsible to the shareholders. It seems to me that those who are responsible ought to be reporting back to the shareholders. The way the auditor is going to write an MD&A is going to be vastly different from the way management writes it. [Also included in 17(b)] **[TI 3/17, p. 22]**

Committee/Staff/Observer
Why not have management write it and the auditor attest to it? **[TI 3/17, p. 22]**

Participant I-11
What are you going to attest to? **[TI 3/17, p. 22]**

Committee/Staff/Observer
I'm talking about the historical aspect of an MD&A, not the prospective aspect. If you agree that the auditor might be able to write a pretty good analysis of operations, but that it is management's responsibility to do that, wouldn't it be useful to you if the auditor lent some reliability to that information? **[TI 3/17, p. 22]**

Participant I-16
I would not grant that an auditor could write a good MD&A. If an auditor could, he's not doing his auditing job; he's spending too much time learning the nuances of the business. Management can write a much better MD&A than the auditor. Secondly, if the auditor is going to get involved in making projections or auditing projections about the future, the auditor is no longer independent. He now has a vested interest in the future financial reports corresponding to those forecasts; his objectivity is lost and I can no longer rely on his opinion. [Also included in 12] **[TI 3/17, p. 23]**

Committee/Staff/Observer

I meant and said to [participant I-11] to exclude the prospective aspect of the MD&A, just the analysis of the historical aspects. **[TI 3/17, p. 23]**

Participant I-16
I would still say it's inappropriate. We're paying management a ton of money to know more about their business than anybody else does, and I want to hear what they know. **[TI 3/17, p. 23]**

Participant I-11
I did not say that an auditor could write a good MD&A, I said an auditor could write a better MD&A than most of those that are being written today, and there's a big difference. I guess my response is that I'm not sure there's a great deal of value-added by having the auditor tell me that when management said that average selling price last year was up 4% that it really was up 4%. **[TI 3/17, p. 23]**

Participant I-7
For manufacturing companies, I want to know that average prices were up 4%, or 2%, or down 1%. **[TI 3/17, p. 23]**

Committee/Staff/Observer
Does that suggest that that be audited? You want to know bad enough to pay for it? [Also included in 17(b)] **[TI 3/17, p. 23]**

Participant I-7
Yes. For example, if you know that inflation is 3%, and management has decided to put a 0% increase for labor costs, I'd like an understanding of that. And that is within the auditors' role to give us comfort on that. [Also included in 17(b)] **[TI 3/17, p. 24]**

Committee/Staff/Observer
Question 7 relates to your interpretation of a modified auditors' report. In certain cases, the auditor considers whether to modify the standard report. One of those cases is when the company faces material uncertainties in the measurement of a liability or asset. If the auditor concludes that the uncertainty is sufficiently important to require emphasis, he or she adds a fourth paragraph to the standard three paragraph audit report. However, auditors seldom add that paragraph in practice because managements and auditors are concerned about reactions of investors. The meeting materials included a standard auditors' report, modified to emphasize a certain matter. Our question is: what would be your reaction upon reviewing that report related to one of the companies that you follow? **[TI 3/17, p. 24]**

Participant I-16
There's a possibility that a major loss will occur. I can't tell you the likelihood of it happening, but management tells me it's very low. I can't tell you the amount but I can conceive it to be very large. **[TI 3/17, p. 24]**

Committee/Staff/Observer
What effect does that have on your recommendation, your pricing, your valuation? **[TI 3/17, p. 24]**

Participant I-16
If I were not aware of it previously, I would probably have lost my job 10 years ago. This is not meant to be disparaging, but my impression is that this is done by the auditor to protect himself from liability rather than to inform investors. At the point where the auditor puts that note in, it's so well known that it doesn't add anything to the basic knowledge that is in the public domain. [Also included in 18(b)] **[TI 3/17, p. 24]**

Committee/Staff/Observer
[Participant I-16], there are 3 items listed on page 8 right in the middle (a, b, and c). **[TI 3/17, p. 24]**

Participant I-16
I chose **d**; uncertain possibility of large loss which would be material. The key things are that the probability of occurrence is indeterminate and the amount of the loss is indeterminate. Again, when that gets into the opinion, everybody knows it. **[TI 3/17, p. 25]**

Participant I-11
In today's world, I would interpret it as meaning that the probability is indeterminate, but that the probability is significant. The auditor is worried that this could well happen. In an ideal world, it should mean **a**, but I don't think that's what it means. Because when 99.5% of the audit reports have three paragraphs, when we see a fourth paragraph, the antenna goes up. **[TI 3/17, p. 25]**

Participant I-12
When you see the fourth one, you say sell. I think that's the general reaction of a lot of people. If we're not aware of this before the auditor gets it, we should have been fired. You find out a lot in the Qs and Ks that don't always make it to the annual report. **[TI 3/17, p. 25]**

Committee/Staff/Observer
So why don't you say sell before you see it in the auditors' report? **[TI 3/17, p. 25]**

Participant I-12
We should have. **[TI 3/17, p. 25]**

Participant I-7
There are instances where I have not spotted something of a material nature. To me, a fourth paragraph is a major flag because it's very rare. When I see it, the immediate reaction is that there is a very significant problem that I have missed and probably others as well. Because if they hadn't missed it, it takes no more than an hour to whistle through the profession. So, in those instances, it generally means negative action on our part and very quickly. **[TI 3/17, p. 25-26]**

Participant I-16
My perception still is that before this happens, the item in question has been discussed at great length by the business press and financial analysts. Financial analysts will each year, just before the annual report is issued, wonder if it will be sufficiently unsettling to the auditors that they will give less than a clean bill of health. We wonder each year when the auditors

will do that just as credit analysts wonder when will [a rating agency] cut the debt rating on a company whose yield spread has gotten so wide that it clearly is not trading where it's rated. There are certain things that you assume are lagging indicators because they're so momentous when they happened. That's one of the points that we're trying to get at in this continuum; you don't want the auditor to be faced with only one alternative which is so drastic that he has to be so careful and wait until overwhelming evidence is in. We think the auditors know so much more than they're allowed to tell that we want them to have a lower standard for making that information available to us. This is not a criticism of the skills of the auditors; this is a criticism of the fact that you're handcuffed from using your skills to impart information to us. **[TI 3/17, p. 26]**

Committee/Staff/Observer
Litigation is a tough issue for auditors because attorneys are not very forthcoming in giving us opinions. Would you like it better if every audit report had an opinion that said that all the material litigation the company is subject to is summarized in footnote x; read it and make your own conclusions? **[TI 3/17, p. 26-27]**

Participant I-16
There are a lot of significant issues that auditors become aware of that are other than an overwhelming piece of litigation. The current auditing standards do not lead auditors to disclose the information that they have. There are a lot of things less serious than litigation that the auditors should disclose. For litigation, I don't have the answer and I don't expect the auditor to handicap the outcome of future litigation. That's why stocks in these companies get marked down and sometimes come back up when a litigation is resolved in a more favorable manner. It's just a huge uncertainty that we have to live with. **[TI 3/17, p. 27]**

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 1(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 1(c)] **[TI 3/17, p. 27-28]**

Participant I-7
You've chosen an easy subject in litigation. What would be of great significance for me, as an example, is if you were dealing with a company that was on a completion basis rather than percentage of completion, and the completion contract would take 2 to 3 years, and you're one and a half year into the contract and, as an auditor, you see that there is going to be a material

write-off. That's something more difficult to see from an external point of view and I would want to see that as a fourth paragraph. **[TI 3/17, p. 28]**

Participant I-12
Unfortunately, the auditors' report has become a matter of form; we have lost the substance. The auditors' report should really be [participant I-11]'s AD&A; it needs to cover a lot of ground. What we have today is boilerplate. There are a lot of issues; litigation is one, environmental, etc. We have allowed the auditors' report to become a form and if the form is slightly different, there's this automatic gut reaction. I don't want to lose the basics that are in place but I think the report could be a lot more useful. **[TI 3/17, p. 28]**

Committee/Staff/Observer
That goes back to the earlier question about standardized reports and it all ties together. [participant I-16], you believe that you would have known paragraph 4 before it ever happened, but don't forget there are thousands of public companies, forget private companies, that have no following on the street, and it might be very informative for the reader of those statements to have the fourth paragraph. **[TI 3/17, p. 28]**

Participant I-16
I'm just saying that if I bought the stock and didn't know about that and it wasn't in the opinion of the prior year, I'm not doing my job. **[TI 3/17, p. 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, comments were made on audit reports.

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 2(b)] **[TI 3/17, p. 30]**

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 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 topic of creditors' objectives and approaches. During the discussion, a comment was made on audit reports.

Participant C-4
I can't remember the last time I've seen a going concern opinion on a financial statement. I don't know how much forward looking work auditors are doing when they're doing their audit work, and then how much historic hindsight review they're doing when they're auditing of financial statements. It's not happening, particularly as I mentioned earlier, in the percentage of completion accounting. [Also included in 12 and 17(b)] **[TC 12/8, p. 74]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Committee/Staff/Observer
Are you interested in seeing a report on internal controls? A long form report that explains what the auditors did and what they found, or would you just prefer that they looked at it and are comfortable, and as long as they don't say anything, that's enough? **[TC 3/11, p. 3]**

Participant C-5
Any of this, when you're forced to come down to a final opinion, it's a plus-minus test. And we'd like the flexibility of applying our own judgments. The creditor always wants the raw data, and then wants to make their own decisions as to how that impacts their thinking. **[TC 3/11, p. 3]**

Committee/Staff/Observer
I'm talking about a separate opinion on internal controls. **[TC 3/11, p. 3]**

Participant C-5
We consider the management letter to be that, although we'd like more depth to it, as opposed to just the opinion, we'd rather have the detail of the findings. Much more of a factual interpretation, less of an opinion. Something typical of what we get by our internal examiners that we would use on a more middle-market, marginal case. **[TC 3/11, p. 3]**

Committee/Staff/Observer
So you're really talking about a down and dirty examination of internal controls and where auditors report on the problems that they found and identified? **[TC 3/11, p. 4]**

Participant C-5
That's right. **[TC 3/11, p. 4]**

Participant C-11
I think it's good to know that the auditors must be nervous about the fact that somebody might sue them, and use a little bit more diligence than they might otherwise do. So I think the auditors should feel a little nervous. That they'd better really get into the stuff or they might be sued. I think that is helpful. On the internal controls, I do think that there's some difficult areas that I would want to feel comfort about, as to what kind of examination really did take place. And I'm thinking of some of these huge off-balance sheet items, such as the foreign exchange contracts, hedging type things. I think it's an interesting avenue to think about. The standard audit letter does not give any feeling one way or another that the critical areas have been looked at in depth. [Also included in 17(a), 18(b), and 19] **[TC 3/11, p. 4]**

Participant C-8
We generally request and often get the management letter prepared by the auditor at the time of the audit, but we can not always get it. So to have something like that incorporated into the financial statements might not be all bad. The second point is that we deal with the construction industry, and quite often the auditors really don't understand the construction business, and it shows in their financial presentation. I guess the point is, something that describes what procedures were undertaken, especially with respect to the work in progress, might be of some benefit. **[TC 3/11, p. 4]**

Participant C-10
As creditors, we're looking for the debt, overall, of the company. But we're still trying to understand just in general whether you folks have said that there's a company here, and it's reasonable. Whereas if you get securitization of assets or hedging, as [participant C-11] mentioned, I think it's a different thing. And I think perhaps there's two levels of types of reports needed here. **[TC 3/11, p. 4-5]**

Participant C-5
. . . I don't mind auditors making assumptions but I need all the details that went into that assumption. Because your biases are different than mine, I have to make my own opinion. It's my money at risk, not yours. I just need to know that what I'm seeing is good raw data, independently observed and factually correct. [Also included in 17(b)] **[TC 3/11, p. 12]**

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 5(b) and 17(b)] **[TC 3/11, p. 14-15]**

Committee/Staff/Observer
The problem is they [the auditors] don't tell you what they do [in respect of the MD&A]. [Also included in 17(b)] **[TC 3/11, p. 25]**

Committee/Staff/Observer
Question number 6 is: should all audit reports be highly standardized, or alternatively, should they be more tailored? For example, should it give more detail about what was done in that particular audit on that particular company, either in terms of the scope of the work or the results of the work? But those are just examples, the question really is fundamentally should the report speak more specifically about the company in a less standardized way, even if nothing is wrong? **[TC 3/11, p. 29]**

Participant C-5
I would agree that it should be more flexible although being in the business of evaluation there is a need to come back to sort of an overall opinion at one point. But the remainder of it, the structure of the opinion statement, is clearly something that I think is too rigid and doesn't allow for that. So I would say yes, it should be flexible but there should be a standard as to requirement for a final opinion and that typically should stick with the words. But the more disclosure I can get on the auditor's findings -- similar to a management letter but actually with more detail-- that is always helpful. And I'd even be willing to take those without assurances about them but just statements of what was found and not. **[TC 3/11, p. 29-30]**

Participant C-14
There's really just two opinions, you're either clean or you're not clean. And I'm not sure how that's done but if I could add one sentence to the opinion it would be: the major risks to the reported net worth of the company are the following... And there's three blanks and you guys fill in the blanks. And that would give you an opportunity to highlight whether it's an off balance sheet item, whether it's inventory controls, whatever it is. And if every statement had that, auditors would have the leverage with management to fill in those blanks. [Also included in 10(d)] **[TC 3/11, p. 30]**

Committee/Staff/Observer
This would be an assertion the auditor would make as opposed to the management saying the three risks we believe the company is at risk in? [Also included in 10(d)] **[TC 3/11, p. 30]**

Participant C-14
You would fill in those blanks. It would be the three major risks on the stated net worth based on our opinion of the reliability of the accounting or validity of the values in the accounts are the following: ... But it's got to be practiced industry-wide or you'd have no leverage over management to get them in your opinion. That's an ideal world. But that's the kind of quality of information that could be in an opinion. [Also included in 10(d)] **[TC 3/11, p. 30]**

Participant C-5
Would they be sized? [Also included in 10(d)] **[TC 3/11, p. 30]**

Participant C-17
And then you start getting into what's the probability and so on. [Also included in 10(d)] **[TC 3/11, p. 30]**

Participant C-15
What type of information do the auditors generally provide to the board of directors? It's very different than the letter that you sign off for the shareholder reports. **[TC 3/11, p. 31]**

Committee/Staff/Observer
I would say no; in fact, what you see that goes to the public is just about what goes to the board in terms of formal reporting. With the exception of management letter comments that are given to the audit committee. Do you see it differently? **[TC 3/11, p. 31]**

Committee/Staff/Observer
Quite differently. Significantly differently. The level of depth is far greater. **[TC 3/11, p. 31]**

Participant C-15
Obviously, companies wouldn't want a lot of the negative stuff disclosed but to the extent that the board of directors has access to that, why shouldn't the investors in the company have access to the same information? The creditors and investors. **[TC 3/11, p. 31]**

Participant C-14
Right. It's not to go and say that these negative things are going to occur, it's just to highlight them as large potential areas for concern; maybe they are areas where you couldn't come up with a hard value. You can't come up with a hard value on legal liabilities or environmental liabilities. But you may in your audit work determine that the degree of variation of potential outcomes is so great that it should be mentioned as a very viable risk. I don't know about size threshold. I'm just throwing out a very idealistic concept. [Also included in 10(d)] **[TC 3/11, p. 31]**

Participant C-12
Being more of a cynic than an idealist, I throw out the idea that advocating a less standardized approach, given the business and legal environments in which we all work and the realities of the marketplace, it's going to be difficult to say certain things, both in terms of what management will accept in terms of the business relationship and particularly in terms of what the lawyers are going to allow to be said. And I fear that in the end it's a good idea. What we get is boilerplate; we think we have information but what we have is boilerplate. [Also included in 10(d) and 18(b)] **[TC 3/11, p. 31-32]**

Committee/Staff/Observer
With that cynical view, then would you just advocate staying where we are? [Also included in 10(d) and 18(b)] **[TC 3/11, p. 32]**

Participant C-12
I would tend to, yes, because I think in the end if we try to broaden what we get, the lawyers and the business relationship is going to give us boilerplate. [Also included in 10(d) and 18(b)] **[TC 3/11, p. 32]**

Participant C-14
Why would it necessarily be boilerplate? Are you saying that every opinion would have the same three issues? Or that because of pressure from management they'd pick issues that aren't truly significant? [Also included in 10(d) and 18(b)] **[TC 3/11, p. 32]**

Participant C-12
I tend to think we'd get the three easy ones raised in a way that waters them down a lot. We've been through this with merger letters and we've seen them expanded greatly. But there's no additional information there. There's more stuff but there's no useful information in this greatly expanded letter. Because the lawyers get hold of it. [Also included in 10(d) and 18(b)] **[TC 3/11, p. 32]**

Participant C-17
It tends to violate the two things I hold dear. One is the independence issue and the other's the consistency. When you start trying to do the hit list for the year and you have some kind of predetermined format, it just becomes subject to all kinds of constraints from the legal end or boilerplate; it tends to have very little value when it comes out. [Also included in 10(d) and 18(b)] **[TC 3/11, p. 32]**

Participant C-6
Considering the market that I deal with, I think standardization is very important because I'm afraid to think of what we'd get if we didn't have standardization. Right now we always fight for more information and if we didn't have a standardized situation I think we would get less than we get now. **[TC 3/11, p. 32-33]**

Participant C-4
We're hitting at what the role of the auditor is. And if we're asking the auditor to make assessments about what the business risks are, I think that's really beyond the scope of what we want. I would be more interested in the auditor disclosing at what level they've audited from a materiality standpoint, and what has taken place from a statistics standpoint. What were the basis for their estimates for doubtful accounts? And on a hindsight basis, how do these current estimates compared to the prior year results? So some format of factual presentation as opposed to their doing the assessment. We'll do the assessment but we would like more information about how estimates were arrived at. [Also included in 9 and 17(b)] **[TC 3/11, p. 33]**

Participant C-14
Couldn't somebody read the generally accepted audit standards guides and more or less get that information? I don't see where that provides any value. On the one hand, we spent the first half of this morning telling you that we want you to use more judgment in how you look at the quality of the numbers. And then on the other hand, everybody's saying well no, don't

say anything that's not standard. I don't think we can have improvement in the quality of the auditing of the information and the assurances it gives without giving you more latitude to be professionals and make judgments and give you some wherewithal to express yourselves. In terms of independence, the degree of standardization in the letter does help maintain your independence; if every letter has certain components but some flexibility within that, then it gives you what you need to be independent and objective but also be critical. [Also included in 17(b)] **[TC 3/11, p. 33]**

Participant C-5
I'm not losing that much in that standard letter; it's boilerplate to the max with the exception of your qualification of the opinion and then the listing of the items that are material in your qualification. As to the issue that [participant C-14] raised about business risks, I want the company's specific risks or those that are unique or different from that which someone would expect for the industry it's in. If I'm in the dry cleaning business and I run 500 laundries, we all know they've got environmental risks and now it's up to me to make a determination of how much they are. I really would only want it if it's a unique risk for that particular company. It may not be the largest risk, in fact, it may be the one that's least risky where I've already assumed there's high risk because of the industry component that it's in. I don't need an auditor to take publicly available information and long perspectives and opinions that are published through analysts and industry watchers and so forth and give that back to me again. In some cases, you have to assume you have no idea who the user is because there's broad distribution of financial statements, but there are other cases where you can be very specific as to what the issues are for the user of the financial information. [Also included in 10(d)] **[TC 3/11, p. 33-34]**

Participant C-12
In general I like [participant C-14]'s idea although if it's going to work we've got to be closer to the ideal than the cynic's view. I'm basically a cynic and I think the risk is that we end up with something extra that looks like more information but isn't. I like the boilerplate we have now which comes down to basically a very important binary decision, qualified or unqualified. One change I would like to see in the letter though is just a listing of how important the business relationship is. You're telling me you've done the work, tell me how biased or unbiased you are. [Also included in 10(d)] **[TC 3/11, p. 34]**

Committee/Staff/Observer
[Participant C-17], when most auditors prepare a management letter, they do so with the supposition that this is a rather internal document to management, in many ways designed to be helpful in assisting somebody to operate a company better and more efficiently in some way and certainly deals with controls. If we made those types of letters part of the publicly available reporting package that is routinely disseminated without restriction or limitation, do you think those letters would become less helpful, that they would become more rigid and encrusted with boilerplate? **[TC 3/11, p. 34]**

Participant C-17
I use the management letter as a source, I mean that as a direct relationship between me and management. Just for the reasons you've mentioned. Because if it became a publicly

available document, especially for a publicly-held company, it would be useless. Very quickly. **[TC 3/11, p. 35]**

Committee/Staff/Observer
I understand. It's troubling because it's only useful if we prepare it for a purpose other than that for which it's used. **[TC 3/11, p. 35]**

Participant C-17
I understand that. The difficulty that we have as lenders sometimes is the level of cooperation. There are managements that don't want to release it. But then we have to ask ourselves the question as to why. I have seen management letters that spell out the difficulties in extreme detail and had I not asked for it, I would have gotten into a situation that would be extremely unprofitable. **[TC 3/11, p. 35]**

Participant C-5
I have traditionally used the management letter as a report of management. The management letter that gets prepared for our company is really a board letter. We start with 58 items and it ends up with a list of 12. The management letter is the 58 item list. If you're thinking management means user then that's not the management letter to me; it's already so scrubbed. **[TC 3/11, p. 35]**

Committee/Staff/Observer
There are other communications that are directed to lower levels of management as well but not that frequently. **[TC 3/11, p. 35]**

Participant C-5
Which is the draft management letter, yes? **[TC 3/11, p. 35]**

Committee/Staff/Observer
The point is that it is considered a rather internal document and not something that's going to be disseminated completely to the public, at least as I understand the mindset of most auditors. **[TC 3/11, p. 36]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 4

Independent audits related to external reporting usually cover only a company's annual financial statements and related notes. Audits currently do not cover other areas of external reporting. Nevertheless, auditors are frequently involved in "checking" other areas, such as the MD&A and historical financial data, that may accompany the audited financial statements and footnotes; the auditors just don't report on their procedures regarding these areas.

a. Would you find it useful for auditors to *report on any procedures they performed* with respect to other areas that accompany audited financial statements and footnotes?

YES *3*
NO*2*

COMMENTS
Participant I-16: Shareholders have paid for auditors' work and should receive the full benefit of their insight and knowledge.
Participant I-7: Especially if auditor found notes or MD&A, etc. particularly lacking in usefulness.
Participant I-9: In most cases.

b. With respect to Management's Discussion and Analysis (MD&A), please indicate your degree of *agreement or disagreement* with the following observations:

SA - **Strongly Agree**
A - **Agree**
N - **Neutral**
D - **Disagree**
SD - **Strongly Disagree**

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
1. Presently, auditors are significantly involved with review of *some* MD&A's, but they don't report on their procedures. Users would like to know to what extent an auditor was involved in a particular MD&A.	*1*	*2*	*1*	*1*	
2. Regardless of auditor involvement in MD&A review, auditor reporting on MD&A should be discouraged, because it would inhibit management's willingness to "discuss" matters not subject to verification.		*1*	*3*		*1*
3. Auditor reporting on MD&A could be helpful to users if the nature of the reporting was limited to giving comfort to disclosed amounts and not addressing the "analysis" language.		*2*	*3*		

[PMQI 3/17, p. 6-8]

QUESTION 6

Professional standards currently require highly standardized audit reports on financial statements. Auditors have little flexibility to customize their reports. Thus, audit reports are generally the same from company to company.

Should audit reports be highly standardized or should they be tailored to the specific company and circumstances? Please indicate whether you AGREE or DISAGREE with each of the following:

	Agree	*Disagree*
a. Auditors' reports should remain highly standardized.	*3*	*2*
b. Auditors' reports should be expanded to discuss in more detail the *scope* of the auditors' work on the specific audit engagement. *Participant I-9:* Boring to outsiders.	*4*	*1*
c. Auditors' reports should be expanded to discuss in more detail the *results* of the audit work on the specific audit engagement. *Participant I-9:* In some cases this could be useful. *Participant I-11:* What does this mean?	*3*	
d. The auditors should grade, or otherwise offer some view of the relative quality of a company's reporting (including the reasonableness of management's assumptions and estimates), in addition to the opinion about whether the financial statements are free from material misstatement. *Participant I-9:* Can you be objective in doing this?	*2*	*3*

	Agree	*Disagree*
e.Something else. Please describe: *Participant I-16:* Auditors should express a judgement on the role of management's estimates and their record of past accuracy and the effect of specific accounting principles chosen when alternatives were available.	*1*	

[PMQI 3/17, p. 9-10]

QUESTION 7

Currently, auditors report on *management's* representations; they make no representations themselves unless they detect a material fairness problem in the financial statements.

Would you find it useful in your work if we expanded the auditors' role and reporting to include *auditors' analysis and commentary* about the following topics? (Please indicate your agreement or disagreement with each item.)

	Agree	*Disagree*
a. Ability of the company to continue as a going concern *Participant I-16:* Auditors should express any doubts.	*4*	*1*
b. Risks and uncertainties facing the company *Participant I-16:* Not the auditors' area of expertise - they might list all conceivable risks to avoid legal liability.	*2*	*3*
c. Prospects of illiquidity	*5*	
d. Significant change-sensitive estimates used in preparing the financial statements, including major assumptions used in those estimates *Participant I-9:* In computing pension liabilities.	*4*	*1*
e. Quality and effectiveness of the company's system of internal *financial* control *Participant I-9:* Only if usual or poor.	*5*	

	Agree	*Disagree*
f. Quality and effectiveness of the company's system of internal *business* control *Participant I-9:* Yes- then we can sue the auditors if the company's controls are lousy!	*3*	*1*
g. Auditors' discussion and analysis of the company's operations		*3*
h. Something else. Please describe: *Participant I-16:* Auditors should stick to their areas of expertise (controls, tests, and going-concern risks). *Participant I-11:* These all would be useful- but I'm not sure they are practical either from the standpoint of liability in litigation or from the standpoint of auditor/client relations.	*1*	

[PMQI 3/17, p. 9-11]

QUESTION 8

In certain cases, the auditor considers whether to modify the standard auditor's report. One of those cases is when the company faces *material uncertainties* in the measurement of a liability or asset. If the auditor concludes that the uncertainty is sufficiently important to require emphasis, he or she adds a fourth paragraph to the standard three paragraph audit report.

What follows on the next page is a standard auditor's report (the first three paragraphs) with an example of a fourth paragraph added to emphasize a material contingency.

What would be your reaction if you reviewed the following report related to one of the companies that you analyze? (*Please check ONE.*)

a. The litigation is obviously important to the company, and you should carefully review Note X and, if necessary, *discuss the matter further* with management.	*4*
b. It is *likely that the company will lose* a very significant amount related to the litigation, otherwise, the auditor would not have taken the unusual step of referring to the matter.	

c. The reference in the auditors' report signals that the litigation is so serious that it *threatens the company's existence.*	
d. Something else. Please describe: *Participant I-16:* The litigation might be significant and should merit further investigation. The auditor is protecting himself by warning the user to beware.	1

Independent Auditor's Report

We have audited the accompanying balance sheets of MLJ Company as of December 31, 19x2 and 19x1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of MLJ Company as of December 31, 19x2 and 19x1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

[PMQI 3/17, p. 9-13]

QUESTION 22

A group that has studied internal control has recently defined it as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

(a) effectiveness and efficiency of operations
(b) reliability of financial reporting
(c) compliance with laws and regulations.

Do you agree with the above definition of internal control? (Please check one.)

Yes *4*
No *1*

If not, how would you change the definition? (Please describe.)
Participant I-9: Too many "weasel" words, make it sharper with less modifiers. [Emphasis on "other", "reasonable"]

[PMQI 3/17, p. 40-41]

QUESTION 23

Please indicate in the spaces below whether you would find helpful management or auditor reporting on internal control. In each space please write one of the following:

Yes - I would find helpful management or auditor reporting on the internal control category, or
No - I would not find helpful management or auditor reporting on the internal control category.

Control Category	*Management Reporting*		*Auditor Reporting*	
	Yes	*No*	*Yes*	*No*
(a) effectiveness and efficiency of operations	*3*	*2*	*2*	*3*
(b) reliability of financial reporting	*2*	*3*	*4*	*1*
(c) compliance with laws and regulations	*4*	*1*	*4*	*1*

[PMQI 3/17, p. 41]

QUESTION 24

a. If you responded NO to reporting on internal control for any category, please indicate the reason(s) for your response. (Please check all that apply.)

It is not possible to report on internal control in the particular category.	
A company's system of internal control in the particular category is not a sufficiently important driver of my investment decision.	
Management or auditor reporting on internal control would be boilerplate and thus not helpful to my work.	*1*
The costs of reporting on internal control are excessive.	
Something else. Please describe.	*Participant I-16:* Auditors lack expertise to evaluate effectiveness and efficiency - it is the purview of management and outside directors. *Participant I-7:* Want the relative party in these cases to make the statement. *Participant I-9:* It is the auditor's job to do this as a routine part of certifying financials. Nothing special should be required. *Participant I-11*: Asking management to report on the effectiveness and reliability of its controls is, in effect, asking management to report on its own competence. Who's going to answer "no"?

b. If you responded YES to reporting on internal control for any category, please indicate the reason(s) for your response. (Please check all that apply.)

Public reporting on the internal control category will result in improvement in internal control. That improvement will reduce the risk of management fraud and manipulation of financial reporting.	*4*
Public reporting on the internal control category will cause directors and management to feel more accountable to the company's investors and creditors.	*3*

The quality of a company's internal control in the particular category is an important factor in assessing the risk and opportunity of an investment decision.	*4*
Something else. Please describe.	*Participant I-16:* Auditors should have the expertise to evaluate the reliability of internal financial reporting and should have some insight into compliance. Management to be held responsible by explicit certifications.

[PMQI 3/17, p. 41-43]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 4

Independent audits related to external reporting usually cover only a company's annual financial statements and related notes. Audits currently do not cover other areas of external reporting. Nevertheless, auditors are frequently involved in "checking" other areas that may accompany the audited financial statements and footnotes; the auditors just don't report on their procedures regarding these areas.

a. Would you find it useful for auditors to *report on any procedures they performed* with respect to disclosures that accompany audited financial statements and footnotes?

__9__ YES __4__ NO

COMMENTS:

Participant C-8: Some reporting on MD&A as outlined in #1 & #3 below would be valuable.

Participant C-13: It is unlikely that such a report would provide meaningful information to users; probably would be "boilerplate".

Participant C-20: Audit fees are already too costly. Do not require work that makes U.S. companies less competitive by raising their cost structure.

Participant C-14: Where there are large off-balance sheet contingencies, I would like the auditors to explain why they believe the potential impacts on the company are not significant.

Participant C-12: Bank analysts rely on MD&A disclosure as much, if not more than on financial statements and footnotes. Given the long term trend toward increased disclosure through the MD&A, failure to cover fully the MD&A is a substantial de facto diminution of the scope of the auditor's role in preparing financial reports.

Participant C-11: If auditors had to officially bless comments that will beyond their area of intelligence, the pressure would be to say noting and give boilerplate. Management should have responsibility for their report to owners.

Participant C-4: We'll do.

Participant C-17: Primarily in the area of contingencies - what was done?

b. With respect to Management's Discussion and Analysis ("MD&A"), please indicate your *agreement or disagreement* with the following observations:

SA - **Strongly Agree**
A - **Agree**
N - **Neutral**
D - **Disagree**
SD - **Strongly Disagree**

A-6,N-3,D-2,SD-1
__ 1. Presently, auditors are significantly involved with preparation of *some* MD&A's, but they don't report on their procedures. Users would like to know to what extent an auditor was involved in a particular MD&A.

SA-2,A-4,N-1,D-5
__ 2. Regardless of auditor involvement in MD&A preparation, auditor reporting on MD&A should be discouraged, because it would inhibit management's willingness to "discuss" matters not subject to verification.

SA-1,A-5,N-4,D-2
__ 3. Auditor reporting on MD&A could be helpful to users if the nature of the reporting was limited to giving comfort to disclosed amounts and not addressing the "analysis" language.

Participant C-11: See above.
[PMQC 3/11, p. 5-7]

QUESTION 6

Professional standards currently require highly standardized audit reports on financial statements. Auditors have little flexibility to customize their reports. Thus, audit reports are generally the same from company to company.

Should audit reports be highly standardized or should they be tailored to the specific company and circumstances? Please indicate whether you AGREE or DISAGREE with each of the following:

Agree Disagree

_7_ _5_ a. Auditors' reports should remain highly standardized.

_9_ _4_ b. Auditors' reports should be expanded to discuss in more detail the *scope* of the auditors' work on the specific audit engagement.

Participant C-4: With exception below.

_7_ _6_ c. Auditors' reports should be expanded to discuss in more detail the *results* of the audit work on the specific audit engagement.

_8_ _5_ d. The auditors should grade, or otherwise offer some view of the relative quality of a company's reporting, in addition to the opinion about whether the financial statements are free from material misstatement.

_3_ __ e. Something Else.
Please Describe:

Participant C-15: Comment on management controls and systems.

Participant C-13: The advantages of highly standardized reporting is that a very visible "red flag" is raised by deviation from one standard report. If reporting became more "fuzzy", this advantage would be lost.

Participant C-14: Every auditor report should by requirement contain a paragraph on the major risks or uncertainties to the auditors degree of confidence in the financial statements:

- concerns regarding inventory build
- potential asset write-downs
- legal contingencies
- environmental
- lack of internal controls, etc.

Participant C-11: The auditor's opinion should be broadened to include a third option between a "clean" and a qualified opinion. The middle option should require the auditor to state what elements of uncertainty exist to raise some question.

Participant C-4: Auditors should disclose how they arrived at estimates used in F/S, what substantive evidence (hindsight review, comparisons, etc.) supports the estimate? Estimates for allowances, cost to complete %, etc.

Participant C-17: A - By industry (i.e., variations should exist from highly specialized industries - utilities, transportation companies, banks and insurance, etc.) but should be consistent within the industry.

D - Disclosure should explain how the auditor reaches opinions (what test or measurements) but should disclaim liability for management supplied information and should not relieve the client's staff from the need for independent investigation.
[PMQC 3/11, p. 8-10]

QUESTION 7

Currently, auditors report on *management's* representations; they make no representations themselves unless they detect a material fairness problem in the financial statements.

Would you find useful in your work to expand the auditors' role and reporting to include *auditors' analysis and commentary* about the following topics? (Please indicate your agreement or disagreement with each item.)

Agree Disagree

_6_ _6_ a. Ability of the company to continue as a going concern

Participant C-4: My job.

_4_ _8_ b. Risks and uncertainties facing the company

Participant C-14: On the previous page I said risks and uncertainties about the reported figures.

Participant C-4: Report facts, we'll make judgments.

_5_ _7_ c. Prospects of illiquidity

_11_ _1_ d. Significant change-sensitive estimates used in preparing the financial statements, including major assumptions used in those estimates

_11_ _1_ e. Quality and effectiveness of the company's system of internal *financial* control

_9_ _3_ f. Quality and effectiveness of the company's system of internal *administrative* control

_1_ __ g. Something Else.
Please Describe:

Participant C-8: B as it relates to D.

Participant C-11: I do not think this should be a required written report, partly because I do not think auditors are competent by training to analyze these issues. However, auditors have to upgrade these skills in order to do a better job in giving opinions, and the focus of AICPA

should be on broadening these skills of auditors - including learning security analysis techniques.
[PMQC 3/11, p. 10-11]

QUESTION 8

In certain cases, the auditor considers whether to modify the standard auditors' report. One of those cases is when the company faces *material uncertainties* in the measurement of a liability or asset. If the auditor concludes that the uncertainty is sufficiently important to require emphasis, he or she adds a fourth paragraph to the standard three paragraph audit report.

What follows is a standard auditors' report (the first three paragraphs) with an example fourth paragraph added to emphasize a material contingency.

What would be your reaction if you reviewed the following report related to one of the companies that you analyze? (*Please check ONE.*)

10 a. The litigation is obviously important to the company, and you should carefully review Note X and, if necessary, *discuss the matter further* with management.

2 b. It is *likely that the company will lose* a very significant amount related to the litigation, otherwise, the auditor would not have taken the unusual step of referring to the matter.

Participant C-12: My second choice would be "c".

1 c. The reference in the auditors' report signals that the litigation is so serious that it *threatens the company's existence*.

__ d. Something Else.
Please Describe:

Participant C-11: As I said on Question 6, we need a recognized middle path so that a question on one aspect of a statement can be differentiated from a going concern question.

Participant C-4: The standard auditors paragraph is a restatement of the footnote, what's the point?

Independent Auditor's Report

We have audited the accompanying balance sheets of MLJ Company as of December 31, 19x2 and 19x1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of MLJ Company as of December 31, 19x2 and 19x1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.
[PMQC 3/11, p. 11-12]

17(d). Frequency of Auditing

Auditor Involvement
The shorter the period of time covered by financial statements, the lower is the need for auditor involvement. The need for timeliness is inversely related to the length of the reporting period and short-period measurements, which are relatively imprecise, are difficult to verify. With periods as short as three months, there seems to be little value to be added from auditor involvement with the financial reporting process. In fact, such involvement is likely to diminish timeliness, a primary attribute of interim reports. If external auditors are to be involved, their role should be to assist enterprises to establish procedures and routines that minimize the time taken to get reports prepared and lessen the probability of material errors or misstatements. [Also included in 11(c)] **[AIMR/FAPC92, p. 38-39]**

In fact, there may be instances in which the auditor's role in annual reporting could be reduced. In companies with strong financial management, effective financial and managerial controls, supplemented by competent internal auditing, a full annual external audit might not be necessary. In those cases, the external auditor would do more systems testing and evaluation than financial statement verification. What might result would be negative assurance on the financial statements in the format referred to in the professional literature as a "limited review." The review work would largely be composed of assessing the effectiveness of financial and managerial control systems and relying on a high-quality internal audit function. [Also included in 11(c)] **[AIMR/FAPC92, p. 39]**

For enterprises that were to discontinue full annual audits, a time would come when a full external examination of the financial statements would be necessary. This might take place quinquennially. The purpose of that examination would be to provide positive assurance by performing a full audit with emphasis on: (a) complete evaluation of control systems, and (b) a retrospective view of annual income for the five-year period by disclosure of all components of income that make one year not comparable with another. Here is another instance where standards implementing the notion of comprehensive income would be indispensable. We suggest that if and when they are promulgated, the SEC authorize a few selected enterprises to experiment with the changed auditor responsibilities that we suggest. [Also included in 11(c)] **[AIMR/FAPC92, p. 39]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Committee/Staff/Observer
We note that some users of external financial reports have suggested that certain companies need not obtain annual audits. They suggest that companies with strong financial management, effective financial and managerial controls, and competent internal auditing could obtain audits less frequently, such as every five years. Our question is: do you agree that some companies should obtain audits less frequently than annually? If so, which companies and why? **[TI 3/17, p. 8]**

Participant I-11
Absolutely not. **[TI 3/17, p. 8]**

Participant I-7
I second that. **[TI 3/17, p. 8]**

Participant I-12
I was thinking the same thing; absolutely not. **[TI 3/17, p. 9]**

Participant I-11
The fact that a company has all these strong managerial controls today doesn't mean they're going to have them 5 years from now, or 4, or 3, or tomorrow. In 5 years, a company can go through 5 CFOs. I think that the annual review of what's going on by the independent auditor is essential. **[TI 3/17, p. 9]**

Participant I-11
A central issue to these discussions is what the role of the auditor is or should be. I think that we may be looking at auditors to do more than they should be doing, using that as an excuse not to do it ourselves. The broad issue is that the financial statements of a company are supposed to accurately reflect the operating performance of that company. The proper role of the auditor is to provide independent judgement that the financial statements do provide an accurate reflection of the operating results. If you think of the role of the auditor in those terms, then expecting of the auditor to get involved in things like the MD&A or the company's forecasts are not appropriate functions for the auditor. On the other hand, issues relating to uncertainty of estimates are related to the auditor's role. To the extent that it is economically feasible, we ought to have a lot more information in that area. There is some limit based on cost-effectiveness. For example, I'm not sure that it is cost-effective to have a quarterly audit. [Also included in 9 and 17(b)] **[TI 3/17, p. 11]**

Participant I-12
I would agree with that. I know that a lot of companies that I cover have their statements audited not only quarterly but before they report, which I find astounding for companies who report 10 days after the end of the quarter. I don't see any need to have an audit done more than annually. I also think that there are areas where the auditor might become involved; measurement uncertainties, for example. Another area for auditors would be looking at transactions with related parties (including major suppliers and major customers). In close relationships like that, that's where a company has the greatest potential for trying to cook the books. An auditor could look at those transactions and determine whether they're being accounted for on an arm's length basis. [Also included in 9 and 17(b)] **[TI 3/17, p. 11-12]**

Committee/Staff/Observer
Should there be any auditor involvement with quarterly reports or once a year is enough? [Also included in 11(d) and 17(b)] **[TI 3/17, p. 12]**

Participant I-16
I think the quarterly issue has to be deferred towards the later discussion of what you want quarterly reports to be, in terms of whether they should be like annual reports, that is, discrete periods, or whether they should be an integral part of the whole year (thus, with some smoothing). You need to decide that before deciding whether they should be audited or not. [Also included in 11(d) and 17(b)] **[TI 3/17, p. 12]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Committee/Staff/Observer
Question number 3. It has been proposed by some that in some cases users might be better served if auditors only did what we now consider a full-scope audit say once every five years, with the years in between involving reviews of internal control and limited assurance reports that might be in the form of something similar to a review report. Would you prefer to migrate to that kind of a world? **[TC 3/11, p. 17]**

Participant C-10
Absolutely not, and I think that's a silly question. I think we should move on to the next question. **[TC 3/11, p. 18]**

Participant C-13
I'm not sure that I'm as dogmatic as I think I heard him say. I think it's an idea that's worth exploring, and not one we should simply reject out of hand. The suggestion that we hear a great deal from the preparer community is that the costs of what we are asking them to provide are excessive. And there can be an argument that the cost of a full scope audit for certain corporations -- now how you define what those corporations might be is a very difficult question -- is not necessary on an annual basis if a sufficient amount of review is done in the interim. **[TC 3/11, p. 18]**

Participant C-5
I agree with [participant C-10] completely and maybe would reverse the question and say: "Who should we do audits for more frequently?" I think that the horizon of all the strategic issues that go into and that have to be a part of the financial presentation is just shortening compared to a few years ago. **[TC 3/11, p. 18]**

Participant C-13
[Participant C-5], you've got an internal auditor with a substantial internal audit staff that reports independently to the board of directors. **[TC 3/11, p. 18]**

Participant C-5
Most internal audit firms are making reports on controls and process as opposed to the representations of financial statements. I would argue that internal auditors are not doing enough on the financial side. The accountants can easily use the internal auditor as a resource

to cut cost but there's no reason why they can't still do the same full-scope audit with a company. I don't believe you have to extend time between audits to cut cost. **[TC 3/11, p. 18-19]**

Participant C-1
From a creditor's standpoint, audits should be done quarterly. We'd love to have everything that we've asked for done every quarter. But there is a cost to that. And my guess is that if you switched around and what you had on here was issuers, they would all be telling me audits are done too frequently and they don't need them done. I don't think you're ever going to get an answer from us that says an audit shouldn't be done annually. Maybe in effect what we need is an audit that has more detail than is done now, that's done every other year, but you still have a normal audit that is done now. Middle sized companies generally don't have large internal audit staffs that can run around and make sure that everything else is going on correctly. I think that's something a large company has and I'm not sure how valuable an internal audit staff is and most companies that we're dealing with don't have it. **[TC 3/11, p. 19]**

Participant C-4
I would think that the objective of this question is to try and find a way for borrowers to reduce their overall costs and I think that providers of credit would be more willing to reduce their costs if they are getting annual audits. A possible solution for borrowers would be to allow us to engage auditors. And then we provide the credit to them and, in essence combine their auditing costs with their credit costs. And we would be much more willing to provide a competitive price to them if we were selecting the auditor. So it's a possible alternative to this question. That would be an ideal situation for us. We could select the auditor we want. [Also included in 17(f)] **[TC 3/11, p. 19]**

Participant C-15
Did you have some criteria in mind in terms of which companies would be audited every five years, as opposed to which ones every year? It would seem to me that would be a difficult decision to make. And just by making that decision, you are making a statement about the quality of the companies that you are going to have to audit every year. **[TC 3/11, p. 19]**

Participant C-13
The SEC has a concept, something called a world-class company, but we never discovered exactly what it was. **[TC 3/11, p. 20]**

Participant C-2
My concern about the question is what do you drop back to then, because we see a wide range of quality of reviews, where some are just a notch below an audit and some have absolutely no disclosures. So what protection do you have then if you have to wait five years to get audited numbers? [Also included in 17(e)] **[TC 3/11, p. 20]**

Participant C-11
I know the genesis of this question. It goes back to the previous discussion we've had. There's something wrong with many audits and so we need to find ways to get this subject out

in the open. Whether this is an appropriate framework is not the point. It's about how we can improve the qualitative aspects of audits. [Also included in 17(a)] **[TC 3/11, p. 20]**

Committee/Staff/Observer
Let me make sure I understand your point. What the people who recommended this had in mind is: "Let's use this recommendation as a way to initiate discussions about quality of audits?" [Also included in 17(a)] **[TC 3/11, p. 20]**

Participant C-11
Yes. [Also included in 17(a)] **[TC 3/11, p. 20]**

Participant C-8
This is already happening at the lower end. Many of our smaller clients are pushing us to accept reviews in lieu of audits or audits every other year, or some combination of a reduction in the quality of the statements, and it's happening quite a bit. And in our industry, it's becoming kind of a competitive issue as well, whether you'll do it or lose the business. So it's already occurring. [Also included in 17(e)] **[TC 3/11, p. 20]**

Committee/Staff/Observer
So you're saying in terms of your ability to write bonds that that's used as a competitive factor in terms of people down the street being willing to accept fewer numbers of audits? [Also included in 17(e)] **[TC 3/11, p. 21]**

Participant C-8
If we've been writing a company's bonds for a number of years, and we've been getting an audit, and then we get a phone call that says ABC company has agreed to write my bonds at the same level with a review. What are you going to do? Then you have to make a decision. So it's already occurring, and more frequently. [Also included in 17(e)] **[TC 3/11, p. 21]**

Participant C-10
I think that the FASB and the auditors in general are under a lot of pressure from the business roundtable and the large corporations on cost issues like that. I think they should stand up to that pressure. The large corporations are trying to control the whole accounting presentation situation in this country in my view. **[TC 3/11, p. 21]**

Participant C-12
I work for a large firm, and I think in general a well regarded firm, but having external auditors come in and look at our files and review our process on an ongoing basis, is a very good and even a necessary discipline for us. And if I think it's good and necessary for me to do it, there's no way I want somebody else to go five years without that. **[TC 3/11, p. 21]**

Participant C-10
. . . I also would vote in favor of as much as you could do quarterly. Again, I think that depends on the size of the companies and costs. [Also included in 17(b)] **[TC 3/11, p. 22]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 3

Some users of external financial reports have suggested that companies with strong financial management, effective financial and managerial controls, and competent internal auditing, need not obtain annual audits of their financial statements. They suggest that those companies obtain audits less frequently, such as every five years.

The meeting participants seemed generally to *disagree* with this suggestion. Please indicate your degree of *agreement or disagreement* with each observation below:

SA - **Strongly Agree**
A - **Agree**
N - **Neutral**
D - **Disagree**
SD - **Strongly Disagree**

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
a. Annual audits create a necessary "discipline" in financial processes and systems that encourages people to follow the "rules".	*5*				
b. Current business strategies change quickly, so it is difficult to keep up with changes even on an annual basis. Longer times between audits would make understanding of the business even more difficult.	*4*				*1*
c. The value of internal audit participation in the *financial statement auditing process* is through cost control, rather than as a substitute of external auditing.		*1*	*4*		
d. Current alternatives, if an annual audit is not performed, are not adequate to provide the disclosures and assurances investors need annually.	*4*	*1*			

	Strongly Agree	*Agree*	*Neutral*	*Disagree*	*Strongly Disagree*
e. Annual audits should continue, but periodically an even more exhaustive audit should be performed. *Participant I-11:* This is a new thought to me - intriguing, but I haven't thought it through.		*2*	*1*	*2*	
f. Something else. Please describe:					

[PMQI 3/17, p. 5-6]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 3

Some users of external financial reports have suggested that companies with strong financial management, effective financial and managerial controls, and competent internal auditing, need not obtain annual audits of their financial statements. They suggest that those companies obtain audits less frequently, such as every five years.

The meeting participants seemed generally to *disagree* with this suggestion. Several observations were made during the discussion. Please indicate your *agreement or disagreement* with each observation below:

SA - **Strongly Agree**
A - **Agree**
N - **Neutral**
D - **Disagree**
SD - **Strongly Disagree**

SA-6,A-7
__ a. Annual audits create a necessary "discipline" in financial processes and systems that encourages people to follow the "rules".

SA-5,A-3,N-2,D-2
__ b. Current business strategies change quickly, so it is difficult to keep up with changes even on an annual basis. Longer times between audits would make understanding of the business even more difficult.

Participant C-14: True but not the reason for annual audits.

A-4,N-3,D-5

__ c. The value of internal audit participation in the *financial statement auditing process* is through cost control, rather than as a substitute of external auditing.

SA-6,A-4,N-2,D-1

__ d. Current alternatives, if an annual audit is not performed, are not adequate to provide the disclosures and assurances creditors need annually.

SA-4,A-3,N-2,D-4

__ e. 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.

Participant C-14: The size of investment banker fees indicates that companies will do anything to raise funds.

A-5,N-1,D-5,SD-1,F-1

__ f. Annual audits should continue, but, periodically, an even more exhaustive audit should be performed.

Participant C-12: e.g., acquisitions, discontinued operations, major revaluations of receivables/loans, etc.

SA-1,A-1

__ g. Something else. Please describe:

Participant C-13: Extensive periodic audit, more extensive than current practice at longer intervals than annually, (? 3 years), with annual assurance from management that controls, procedures and operating conditions have not materially changed.

Participant C-14: The annual audit works - this issue is not worth the time we have devoted to it.

Participant C-11: The focus should shift to periodic, in-depth audits of critical aspects, including systems controls or asset impairment, that are not necessarily done annually. The annual audit seems to focus on everything to a mechanical and shallow review in a time pressure framework, rather than forcing the auditor to see the broader picture of where problems may exist.

Participant C-17: D) Except possibly in the case of public companies through SEC disclosure requirements. I doubt the SEC would permit anything less than annual audits in any event.
[PMQC 3/11, p. 4-5]

17(d). Frequency of Auditing–Page 9

To improve financial reporting, from an analyst's point of view, [one analyst] recommended . . . the following. . . : [Also included in 1(b), 2(c), 3(a), 8(d), and 15] **[BEAR STEARNS, p. 2]**

Require that audits be performed on quarterly reports. **[BEAR STEARNS, p. 2]**

17(e). Reviews

[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, a comment was made on auditor involvement.

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 2(d)] **[TC 12/8, p. 43]**

[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, a comment was made on auditor involvement.

Participant C-2
[Cost] is a real concern I think for the small banks, small business. We're seeing already a dramatic trend from audited to reviewed and even more so to compiled statements now with no disclosures because of this, I'm sure. [Also included in 10(c)] **[TC 2/2, p. 33]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Participant C-6
At the level of the businesses that I deal with, which is on a much lower level than many of the people here, we strive to obviously get better than a compilation statement, and if we can get a review statement, well, we're very happy about that. But in many cases, we just get no disclosure whatsoever, that is, no footnotes, in a review statement. It's beyond me how an accountant can put out a review statement without putting any footnotes in the statement. Basic information, such as liens on assets, term loan covenants, inventory receivables are not discussed, and possibly bad receivables that may be in there. That's the most disappointing thing to me. When I strive to get a review statement, but get no footnotes, I think that's lacking. [Also included in 17(a)] **[TC 3/11, p. 13]**

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 2(d) and 17(a)] **[TC 3/11, p. 16]**

Participant C-2
My concern about the question [that is, to have audits every five years] is what do you drop back to then, because we see a wide range of quality of reviews, where some are just a notch below an audit and some have absolutely no disclosures. So what protection do you have then if you have to wait five years to get audited numbers? [Also included in 17(d)] **[TC 3/11, p. 20]**

Participant C-8
This is already happening at the lower end. Many of our smaller clients are pushing us to accept reviews in lieu of audits or audits every other year, or some combination of a reduction in the quality of the statements, and it's happening quite a bit. And in our industry, it's becoming kind of a competitive issue as well, whether you'll do it or lose the business. So it's already occurring. [Also included in 17(d)] **[TC 3/11, p. 20]**

Committee/Staff/Observer
So you're saying in terms of your ability to write bonds that that's used as a competitive factor in terms of people down the street being willing to accept fewer numbers of audits? [Also included in 17(d)] **[TC 3/11, p. 21]**

Participant C-8
If we've been writing a company's bonds for a number of years, and we've been getting an audit, and then we get a phone call that says ABC company has agreed to write my bonds at the same level with a review. What are you going to do? Then you have to make a decision. So it's already occurring, and more frequently. [Also included in 17(d)] **[TC 3/11, p. 21]**

Committee/Staff/Observer
Question 5 talks about the levels of assurance auditors can provide. Right not, you can either have an audit, or you can have a negative assurance called a review. And those are the only choices you have. The first question is: under what circumstances are you willing to accept the lower level (a review)? **[TC 3/11, p. 27]**

Participant C-5
At a minimum, obviously, we'd prefer to have audited statements; we weight them heavier in a credit decision. But we're making our own risk return decision exposure side versus the penalty to the customer for having to pay for that. The quality of what you get, even in an audited statement, at the small end, is really just a compilation with a high degree of assurance. We end up doing our own exams as a supplement to that, anyway, on most of them. And borrowing is always secured at that level, so that we're very focused on the current quality of our collateral. We spend a lot of time digging into it for our exam process. So, I would advocate having something that will allow us to get assurance on key elements

instead of the broad set of financial statements. Things like recognition practices may be less important. Things like inventory and receivables become very important for secure lenders at the small end. And so an assurance on certain key items, or critical items at that level, which would allow for a slightly incremental cost but not a substantial difference would be important to me at that segment. **[TC 3/11, p. 27]**

Participant C-6
We try to adhere to the same type of criteria that [participant C-5] just mentioned as far as dollar levels with regard to the quality of audits. Most commonly we'll look at review statements. We try to derive additional information through direct dialogue with management and with the accountants. **[TC 3/11, p. 28]**

Participant C-8
We generally look at the corporate structure to see if it's a complicated corporate structure; it's usually just an operating company. We'll look at the balance sheet fairly closely; is it a clean balance sheet, pretty straight forward? Are the principals willing and able to give us support and schedules in most of the major items so that we can in fact do all the verifications? And finally, is the credit being requested reasonably conservative in relation to the size of the company? If you have to stretch any of those issues, then we push for an audit. But in the last year or two, competition has been a serious issue with respect to the quality of financials. **[TC 3/11, p. 28]**

Participant C-2
In larger credit granting institutions, you do have the ability to go out and do your own audit. But in a small bank like mine, we will sometimes step back from an audit to a review, but use agreed-upon procedures with the accounting firm to do a current asset and current liability audit for us, where we feel that we really need the assurance. **[TC 3/11, p. 28]**

Committee/Staff/Observer
Would there be advantage to being able to get higher verification on some things and lower on others? I think I've heard [participant C-5] say he'd like that. **[TC 3/11, p. 28]**

Participant C-8
It's really the individual quality of the statements. I can send you review statements that are probably better than 80% of the audits we get in terms of their completeness and the amount of work that's put into them. **[TC 3/11, p. 28]**

Participant C-4
In many instances, we'll get audited balance sheets and review financial statements. And we would be willing to accept the audit of certain accounts where there are material disclosures. **[TC 3/11, p. 29]**

[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 auditor involvement.

Participant C-7
I have mixed emotions. The threat of litigation has made the accounting profession more quality conscious but I also see that the added cost that that's entailed has led to a lot of boilerplate coming into the financial reporting. And then the movement away from audited statements, in part because the accountants are coming back to the client saying this is what it's going to cost you for an audit now to protect us and so they're saying we don't want to bear that cost so step it back for us. I think there's a net loss in that respect. [Also included in 18(b)] **[TC 3/11, p. 62]**

17(f). Other

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), 1(c), and 13] **[SRI, p. 55]**

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), 1(c), and 10(d)] **[PREVITS, p. 12]**

[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, a comment was made on auditor involvement.

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 2(d)] **[TC 12/8, p. 43]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of auditor involvement.

Participant C-4
I would think that the objective of this question is to try and find a way for borrowers to reduce their overall costs and I think that providers of credit would be more willing to reduce their costs if they are getting annual audits. A possible solution for borrowers would be to allow us to engage auditors. And then we provide the credit to them and, in essence combine their auditing costs with their credit costs. And we would be much more willing to provide a competitive price to them if we were selecting the auditor. So it's a possible alternative to this question. That would be an ideal situation for us. We could select the auditor we want. [Also included in 17(d)] **[TC 3/11, p. 19]**

Participant C-17
Should there be a review board in terms of the quality of the practitioners? **[TC 3/11, p. 29]**

Participant C-8
The same firm that audit a grocery store can't necessary handle a construction contractor or a manufacturer. And I think that's what we see in the low end a lot. **[TC 3/11, p. 29]**

Participant C-7
We've had experience with a number of our customers where we've gone back to them when they've come in with credit requests and said you've got to change your auditors or your accounting firm. We're dissatisfied with the quality of work. [Also included in 17(a)] **[TC 3/11, p. 29]**

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), 3(e), 5(b), 10(c), and 13] **[KPMG BANK STUDY, p. 38]**

- Examiner findings and comments [Also included in 13] **[KPMG BANK STUDY, p. 39]**

18. Structure and Process

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	□

18(a). International Harmonization of Standards

[Context] The AIMR position paper provides a summary of the section (pages 11-20) entitled "The Changing World and Its Implications for Analysis," which describes the effects on financial analysis and financial reporting of three major phenomena:

> The world constantly is changing and everyone must adjust to accommodate those forces over which they have no control. The nature and implications of three major phenomena that are expected to affect financial analysis and analysts are considered here. Those matters also have considerable influence on the views and conclusions expressed later in the paper. [Also included in 7(b), 16(a) and 19] **[AIMR/FAPC92, p. vi-vii]**
>
> First, globalization of the capital markets and the spread of free enterprise throughout the world have enormous implications for analysts. Capital flows freely across many national borders. The need for information to compare investment opportunities of disparate character is greater than ever. Thus, an increasing amount of attention has been given to the activities of the International Accounting Standards Committee (IASC) and the International Organization of Securities Commissioners (IOSCO). We express our support for continued advancement of their work, but we also express concerns over the possible lowering of standards of accounting, disclosure, reporting frequency, and attestation. In sum, we support rapid internationalization as serving well the interests of financial analysts, but only if it is done so as to raise the level of information internationally without lowering it domestically. **[AIMR/FAPC92, p. vii]**

[Context] Those two paragraphs introduce the following excerpts pertaining to the first major phenomenon listed. Excerpts pertaining to the other two phenomena are included primarily in 16(a)-Databases, 7(b)-Other intangible assets, 8(b)-. . . [A]ccounting for business combinations, and 19-financial instruments and off-balance-sheet financing, with a few excerpts included in other categories.

> <u>Globalization and the Spread of Free Enterprise</u>
> Recent decades have seen an astonishing disappearance of geographical barriers both physical and psychological. Markets for products have become international -- no longer do we think of the United States alone when we speak of market share in automobiles, electronic equipment, computers and a variety of other industrial and consumer goods. Financial markets have not escaped this phenomenon. Large companies raise money throughout the world, in forms and locations that offer the most favorable terms. Investors follow suit by making capital available for equity investing around the globe. **[AIMR/FAPC92, p. 11]**
>
> There is no sign that globalization of the capital markets will not continue until such time as almost all barriers have disappeared. The year this report is being written, 1992, is shortly

before the year that the European Community is scheduled to spring into full-blown being. Intra-European economic barriers between its members are going down rapidly -- and other non-member European countries are waiting to be admitted. Even that bastion of autonomous independence, Switzerland, appears ready to join. The collapse of communistic socialism in Eastern Europe has implications not only for those countries, but also for many "third world" countries that emulated them. **[AIMR/FAPC92, p. 12]**

All of this change and its projected continuance has dramatic implications for financial analysis, many of which go beyond the limited scope of this report. They are caused by differences in languages and cultures, laws and ethics, business practices, and financial institutions and instruments. With respect to financial reporting alone, there are a myriad of problems to consider. These encompass analysts' needs for internationally acceptable standards of financial reporting, including common accounting methods, adequate detailed disclosure, sufficient frequency of reporting, and credible auditing or other reliability enhancement. **[AIMR/FAPC92, p. 12]**

Common Accounting Methods

The International Accounting Standards Committee (IASC) has done an admirable job with meager resources in bringing together accounting and standards-setting bodies from around the world to deal with the accounting standards problem. It has had two major accomplishments to date. First, it has codified accounting practice around the world and deemed idiosyncratic methods unacceptable while allowing to stand alternative methods that were followed in sizable portions of the world. Its second accomplishment is its "Improvements project" to eliminate most remaining alternatives in practice while at the same time initiating new projects (such as joint venture accounting and financial instruments) on which few national standards currently exist. **[AIMR/FAPC92, p. 12]**

We applaud the IASC for its productivity. But we also must look carefully at factors that may impair its ongoing effectiveness. First, it now is entering politically precarious territory and without the power of a Securities and Exchange Commission to back it up. Although its work is supported by the International Organization of Securities Commissioners (IOSCO), its authority is limited, as is that of the IASC itself, to the willingness of sovereign governments to be persuaded to adopt its views. Second, the politics of international standard setting may be exacerbated because the IASC is composed primarily of representatives of national professional accounting bodies, such as the AICPA in the United States, rather than its being an amalgamation of national standard-setting bodies. Third, in the United States it is the FASB that is designated to determine accounting standards. Under its rules of due process it is almost impossible for the FASB to participate directly in international standards setting, but it has reorganized its internal procedures to take account of international developments and sends an observer to all meetings of the Board of the IASC. **[AIMR/FAPC92, p. 12]**

Adequate Detailed Disclosure

This is an adjunct to the problem of common accounting standards. It raises the question of the extent to which an enterprise's securities can be issued and traded in a foreign country while adhering only to the disclosure standards of its home country. This is a current issue involving movement on the part of the SEC and its counterparts in the United Kingdom and Canada to allow filings that meet their home-country requirements also to be acceptable in the other two countries. An experiment in certain Canadian offerings is in effect now. Given that the U.K. is a member of the EC, this may be considered by some as a first step on the way to accepting security offerings that meet the quite diverse disclosure requirements of all the various EC countries. **[AIMR/FAPC92, p. 12-13]**

We believe that, at a minimum, IASC accounting standards (IASC GAAP) should be adhered to by foreign companies registering securities in the United States. But we are unable to answer the resultant question as to whether U.S. companies should be allowed also to follow IASC GAAP rather than FASB GAAP when they register their securities in the U.S. A yes answer would endorse some loss of information, a position no analyst wants to support. A no answer implies special treatment for foreign companies to compete in U.S. capital markets without disclosing all that U.S. companies must, thus perpetuating noncomparable financial reports between U.S. and non-U.S. issuers. Furthermore, if the SEC were to accept IASC GAAP for all public companies, their reports would be noncomparable with those of private companies who (presumably) would continue to follow FASB GAAP. **[AIMR/FAPC92, p. 13]**

We believe, for the time being, the SEC should continue to require foreign companies to provide a reconciliation from the accounting standards followed in their home country to U.S. GAAP. We believe that foreign companies should be allowed and encouraged to adopt IASC GAAP, but that the reconciliation to U.S. GAAP should continue to be required at least until the IASC Improvements Project is completed. At that time, we shall need to reconsider our position. **[AIMR/FAPC92, p. 13]**

Frequency of Reporting
In the United States, publicly owned companies are required to report quarterly on Form 10-Q filings with the Securities and Exchange Commission. Exchange regulations require listed firms to send quarterly reports directly to shareholders. Private companies also tend to report quarterly to their creditors and other financial statement users. In most other countries financial reports are issued semi-annually; in a few countries, only annual reporting is the norm. Some people now advocate that the United States abolish its quarterly reporting requirement and regress to semi-annual or even annual reporting only. [Also included in 11(a)] **[AIMR/FAPC92, p. 13]**

The membership of AIMR unequivocally supports quarterly financial reporting and is absolutely opposed to any movement to eliminate it. Our arguments on that subject appear in more detail later in this report. At this point, we wish merely to point out that some of the impetus for the eradication of quarterly reporting results from the phenomenon of globalization. We believe that financial markets, both domestic and foreign, are best served by frequent and even-handed dissemination of information to the public. We urge the Congress of the United States, the SEC, and its international counterpart, IOSCO, to heed the admonitions later in this report on the subject of quarterly reporting. [Also included in 11(a)] **[AIMR/FAPC92, p. 13]**

Auditing or Other Forms of Enhancing Financial Statement Credibility
In recent years the IASC has received a great amount of attention as it attempts to codify a globally acceptable set of accounting standards. Alternatively, more people should become

informed of the role of a parallel organization, the International Federation of Accountants (IFAC) and its Auditing Practices Committee (IAPC), because its work is as necessary to the integrity of financial statements as is the IASC. As financial statements begin to conform to a worldwide GAAP, we need also to be able to rely on them. **[AIMR/FAPC92, p. 13-14]**

Although we hold no brief for considering "made-in-America" audits supreme, we are aware that agreed-upon audit standards in this country -- general standards, standards of fieldwork, and standards of reporting -- are in some ways superior to those elsewhere in the world. In particular, we regard independence as an essential prerequisite to attestation. Yet, there are countries where the law mandates that the auditor be a member of the corporate governing board. In some countries the education requirements for auditors may be inadequate to keep them up to date with the electronic systems and sophisticated financial affairs of multinational companies. **[AIMR/FAPC92, p. 14]**

We believe that international agreement on auditing standards and practice would improve the standards of practice in all countries, including our own. For example, the recent collapse of the Bank for Credit and Commerce International (BCCI) indicates how a truly determined international renegade enterprise can shelter itself from effective auditing by hiding its records and conducting its corporate affairs in jurisdictions with less-than-strict financial regulation mores. We seek, together with professional accountants worldwide, means to prevent a recurrence of that unfortunate calamity. **[AIMR/FAPC92, p. 14]**

Preclude the "Lowest Common Denominator" Syndrome

As globalization of accounting, disclosure, reporting frequency, and auditing standards proceeds, we must guard against the penchant to avoid difficult choices. Standards differ around the world in substance and in quality. It is always easier to lower the barriers than to raise them, thereby adopting the basest rule rather than the most elevated. AIMR stands behind those who are willing to make hard choices and raise the level in the majority of the world (including, in some instances, the United States) rather than acquiescing in the lowest common denominator. Likewise, we anticipate that standards setters, regulators, and professional accountants all will aspire to raising global financial reporting to the highest and most useful level attainable. **[AIMR/FAPC92, p. 14]**

The preceding section of this report deals with globalization of the securities industry. In many respects that happening has been made possible by computing power aided by similar advances in telecommunications. As a result, money can be moved around the world quickly to take advantage of investment opportunities wherever and whenever they appear. Records can be updated instantly. Information may be formatted for computer processing and transmitted via modem or equivalent. [Also included in 16(a)] **[AIMR/FAPC92, p.14-15]**

[Context] The following brief summary of the topic "The Standard-Setting Process," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Several topics are covered in this section. First is our assertion of support for the continued development of globally acceptable accounting standards. That support is accompanied by a discussion of the problems that we expect will be encountered in the quest for worldwide standards. [Also included in 18 (d) and 18(e)] **[AIMR/FAPC92, p. x]**

Second, we express our support for the standard-setting process in the United States and for the FASB as an institution. We provide refutation to many of the criticisms directed against it. We do not believe the FASB is to blame for many of the complications in financial statements today, nor do we believe that it has issued too many standards too quickly. We disagree with those who say its standards are too theoretical, that the cost of implementing them is too great, or that the FASB is inimical to the interests of financial statement preparers. Rather than following due process too little, we believe the FASB follows it too much. The reasons supporting these beliefs are set forth in the report. [Also included in 18 (d) and 18(e)] **[AIMR/FAPC92, p. x]**

Finally, we emphasize the needs of financial statement users in the standards-setting process. We argue that users of financial statements are also the owners of the enterprises being reported upon, and it is the users who, in addition to receiving the benefits, ultimately bear the cost of providing financial reports. We suggest that user viewpoints be incorporated in the standard-setting process through their direct participation as members of the FASB, in addition to the current practice of their providing written comments and oral testimony. [Also included in 18 (d) and 18(e)] **[AIMR/FAPC92, p. x]**

[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.

<u>National Standards-Setting for Global Financial Markets</u>
As discussed in some detail earlier in this report, financial markets have transcended national boundaries and the sovereignty of individual states. Accounting standards continue to be promulgated locally with all of the expected chauvinism, conflicts, cultural biases and other ingredients of heterogeneity. The International Accounting Standards Committee faces a huge task as it strives to set forth a common set of standards without the authority to enforce adherence to them. Given the degree of disputation in any one country when major new standards are proposed, international disagreement can be expected to be a multiple of that. **[AIMR/FAPC92, p. 52]**

We have been favored in the United States with a body of accounting standards and financial disclosure requirements that is more comprehensive than anywhere else in the world. We also have a single set of accounting standards that, with only a few exceptions, apply equally to all enterprises, large and small, public and private. Standard-setting generally has been done in the private sector, although not without intensive oversight and occasional supersession by the Federal government. In many other countries accounting standards are set by law or government fiat, sometimes by law intended primarily to serve purposes, such as tax assessment, only peripherally related to financial reporting. Some countries set rigid legal requirements for company accounts, but allow more flexibility for consolidated financial reports, Japan and France being prime examples. Some countries have written and agreed-upon conceptual frameworks to support their standards, in others the framework is implicit only. **[AIMR/FAPC92, p. 52]**

All of these differences, until somehow resolved, have certain deleterious consequences. Until such time as there are universal financial reporting precepts the risks associated with cross-border financing will remain high. Stock exchange listings will necessarily remain parochial.[21] Transaction costs relating to trades of foreign securities will remain high. These consequences, although expensive, are far less costly than would be the degradation of the integrity and efficiency of the capital allocation process in North America should there be significant reductions in the frequency, quality or quantity of financial information available now. **[AIMR/FAPC92, p. 52-53]**

We are in somewhat of a quandary as to the best course to take to achieve truly meaningful and generally accepted international accounting standards. Our suggestions here are less forceful than elsewhere in this report. Much of the subsequent discussion of this topic consists of questions, not answers. As we consider the set of steps that can be taken to achieve true international standards some of the questions that arise are: **[AIMR/FAPC92, p. 53]**

- Can a single set of standards be truly compatible with business methods and practices that vary from culture to culture around the world? **[AIMR/FAPC92, p. 53]**

- Will competition amongst national interests cause international standards to be weak or robust? How many alternative choices should be allowed? Will smaller, weaker, less developed countries be able to influence standards setting? How and to what extent? **[AIMR/FAPC92, p. 53]**

- What enforcement mechanism(s) will work? Is IOSCO the proper body to bring compulsion to international standards? What about countries that do not have representation on IOSCO? Are there more appropriate international bodies? Are non-adopters of international standards to be shunned in the capital markets of the world? **[AIMR/FAPC92, p. 53]**

- Is the IASC as presently constituted the proper body to formulate international standards? Should the accounting profession, founder of the IASC, be supplanted by some other group such as national standard-setting organizations, thus making the IASC into a supra-national standards-setting body? **[AIMR/FAPC92, p. 53]**

- How should the views of interested parties be presented to the IASC? Should, for example, each national or regional organization of financial analysts offer its separate opinions, or should analysts worldwide attempt to reach consensus first? The same questions apply to professional accountants and business enterprises. **[AIMR/FAPC92, p. 53]**

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[21] AIMR disagrees with William H. Donaldson, President of the New York Stock Exchange. He is portrayed in a *Wall Street Journal* article ("Big Board, SEC Fight Over Foreign Stocks", May 13, 1992, Page C1) as wanting to "...persuade the Securities and Exchange Commission to soften strict U.S. rules so that foreign companies with looser financial disclosures can be traded on the Big Board."

- Will international standards be accepted by the SEC as an alternative to U.S. standards? Will they be accepted only for foreign companies or for all registrants? If so, what would be the effect on privately-owned U.S. companies? Would they also have to follow international GAAP? If not, would a separate set of national accounting standards have to be maintained solely for them? **[AIMR/FAPC92, p. 53]**

There are many other unanswered questions. This report is too brief to present all of them or to explore their answers in reasonable depth, particularly since so many of them are interrelated. In any event, financial analysts expect to play a major role in formulating answers to them. We are pleased with the extent of our participation on the international scene to date. We plan not only to maintain our presence, but to expand it as we continue to approach a world of finance that is truly global. **[AIMR/FAPC92, p. 54]**

[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, 5(a), 8(c), 11(a), 12, 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), 4, 5(a), 8(c), 11(a), 12, 18(c) and 18(d)] **[AIMR/FAPC92, p. 60]**

Those two paragraphs introduce the following summary of a position taken by the Committee.

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 1(d)] **[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. We disagree. Our reasons are discussed in detail elsewhere in this report. [Also included in 1(d)] **[AIMR/FAPC92, p. 60]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. When discussing whether they make adjustments for goodwill in their analysis, a comment was made on international considerations.

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 1(b) and 7(a)] **[TI 10/16, p. 38]**

[Context] Meeting of the Investor Discussion Group on October 16, 1992. At the end of the meeting, investors were asked a specific question about the availability of information in other countries compared to the U.S.

Committee/Staff/Observer
Coming back to [participant I-6] point about the lack of production data. Do you have an explanation for the fact that you find more disclosures of production data overseas than in the U.S. because, to my knowledge, those disclosures are not required anywhere? [Also included in 13] **[TI 10/16, p. 59]**

Participant I-6
The only explanation I would have for it is that management of foreign companies tend to feel that it's a better way to communicate with shareholders on how they're growing the company. It is more readily available and more part of their financial disclosures and their presentations to the financial community overseas than it is here. Here, they focus on the financials more, which is very important, but in the basic industries it's hard to get to those numbers without understanding the production data. It seems that the companies here are very reluctant to disclose that information. [Also included in 13] **[TI 10/16, p. 60]**

Participant I-2
You're also talking about situations where the extractive industry is a much more greater % of GNP than here. In the S&P 500, I think metals are maybe less than 1%. But if you're talking about South Africa or Australia, for example, it's a much bigger %; in Canada, gold is 5% of the S&P equivalent in Canada. [Also included in 13] **[TI 10/16, p. 60]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of structure and process.

Committee/Staff/Observer
Question 13 moves us to the process of establishing reporting standards and improving external reporting. The first group of questions relate to U.S. investors investing in foreign securities, a trend that many expect to intensify. As a result, U.S. investors need to use external financial reports prepared under accounting and disclosure rules that are different from U.S. rules. Our question is: does relying on financial reports based on accounting rules other than U.S. rules negatively affect your investing decisions and the time and effort needed to complete the analysis process? For example, would using foreign financial statements on a different basis than U.S. GAAP require analysts with experience on that basis of accounting? Would certain benchmarks that you use in your analysis have to be modified? **[TI 3/17, p. 50-51]**

Participant I-12
When I looked at foreign companies, I tried to do my best to try to translate them as close as I can to U.S. GAAP to deal with something that is familiar. I have used our sell-side analysts to perform that work and it is an enormous effort. It's a deterrent to getting involved with foreign companies. To the extent possible, I like to look at foreign companies with registered ADRs; that counts out a large part of the world because many refused to do that because of the reporting requirements. But I have to deal with something I'm familiar with or sit down and spend a lot of time with analysts who operate in that foreign market and know the background, because otherwise the traps and the pitfalls are just enormous. **[TI 3/17, p. 51]**

Participant I-5
It was very hard to learn the U.S. GAAP language the first time; trying to learn other accounting languages is very hard also. There is a big cost there. **[TI 3/17, p. 51]**

Participant I-7
It depends on the organization. Our organization has set up groups in the international marketplace who understand accounting and political differences in the companies and the countries that they're following. We're constantly running into valuation problems in terms of trying to melt that information. **[TI 3/17, p. 51]**

Participant I-5
So your answer is that you don't even bother having the same people trying to do both parts because it's too hard? **[TI 3/17, p. 51]**

Participant I-7
And very time-consuming. **[TI 3/17, p. 51]**

Participant I-12
I work for an organization that has a very large international portfolio. Historically, we have been divided into the international (country portfolio managers) and domestic industry analysts. Over the last 4 or 5 years, we have been encouraged as analysts to become global analysts. It's a lot of work and effort but there is no doubt in my mind that it is the way this business is going; with the communications that we have today, the capital needs, we won't have any choice in the matter. But the learning curve is very steep; it's not easy. **[TI 3/17, p. 52]**

Committee/Staff/Observer
Our next question relates to the harmonization of accounting standards, that is, the use of a single set of accounting standards for all companies interested in raising capital in foreign markets. We note that there is growing support for international harmonization of accounting standards. Currently, standards issued by the IASC seem to represent the most realistic basis for international harmonization. IASC standards are less detailed than the U.S. standards and would probably result in financial reports containing less information than currently in U.S. reports. Our question is: would you favor the use of one set of accounting standards, presumably IASC standards, by all companies worldwide? **[TI 3/17, p. 52]**

Participant I-7
Does that mean that we have to give up what we have here? **[TI 3/17, p. 52]**

Committee/Staff/Observer
Yes. **[TI 3/17, p. 52]**

Participant I-7
Then the answer is no. I don't want to give up what I have here; what we have here is the best. **[TI 3/17, p. 52]**

Participant I-16
I agree with [participant I-7]. **[TI 3/17, p. 52]**

Participant I-12
I wouldn't want to give up what we have here. I think we need something where we can look at companies on a comparable basis but I'd fight to the death to keep what we've got. **[TI 3/17, p. 53]**

Participant I-16
At the same time, we should not try to prevent foreign companies from raising capital in our markets. To the extent that we can tighten their disclosure requirements, that would be terrific. But if they don't want to meet our standards, I don't think we should foreclose them from our markets. It may sound inconsistent but I don't think this country really gains by closing itself off to the rest of the world. **[TI 3/17, p. 53]**

Committee/Staff/Observer
You would allow U.K. companies to raise capital in the U.S. markets with no reconciliations or no additional disclosures? **[TI 3/17, p. 53]**

Participant I-16
I didn't say no additional disclosures. I would not necessarily hold them to go fully to our standards and report on U.S. GAAP. I would expect them to make some kind of reconciliation. **[TI 3/17, p. 53]**

Participant I-11
I disagree with that. **[TI 3/17, p. 53]**

Committee/Staff/Observer
The second bullet from the bottom on page 17 of the meeting materials is [committee/staff/observer]'s point. Assuming that you answer no as you did, would you then favor a requirement for foreign companies to provide a reconciliation of earnings to U.S. GAAP? **[TI 3/17, p. 53]**

Participant I-16
I would settle for that; I would prefer the first one (U.S. GAAP statements) but I would settle for that. **[TI 3/17, p. 53]**

Participant I-11
It seems to me that if they're going to play in our gym, they have to play with our ball. I can't see why a company that wants to raise public capital in the U.S. should be allowed to do anything other than report under U.S. standards. **[TI 3/17, p. 54]**

Committee/Staff/Observer
Even if that means driving capital away from the U.S. markets? **[TI 3/17, p. 54]**

Participant I-11
So be it. **[TI 3/17, p. 54]**

Participant I-7
I think that's a function of the investor. If the investor chooses to accept the information as released or with a reconciliation of earnings, that's up to the investor. I would challenge any process that would drive foreign companies away from our markets. **[TI 3/17, p. 54]**

Committee/Staff/Observer
What would you think would happen in the marketplace if a U.K. company filed information in the U.S. that was solely based on U.K. standards, and we allowed that, what do you think would happen? **[TI 3/17, p. 54]**

Participant I-7
Since I don't follow those companies, I can only say anecdotally that the market would place a different, likely a lower, valuation on the company. But it's only anecdotal. **[TI 3/17, p. 54]**

Participant I-12
Our reporting standards are built around the notion that the SEC has a role to protect investors. In general, that protection has taken the form of "buyer beware", that is, companies should disclose all the necessary information and if an investor still wants to buy a dog, he can. To me, that's fair. I agree with the notion that it doesn't make sense to preclude foreign companies from raising capital here. We have enough precedents in this country of all kinds of filings where only sophisticated investors (large institutions) are allowed to participate. There is a presumption that professional analysts know enough about an industry or a company that we can make a reasoned judgement based on lesser disclosure. Something like this might work in terms of foreign companies. An individual investor could participate through the device of a mutual fund if that's what he wants to do. But I don't think we should give up our disclosure rules. **[TI 3/17, p. 54-55]**

Committee/Staff/Observer
I could make the argument that if you can make do with those companies with lesser disclosure, why can't you make do with lesser disclosure with all companies, including U.S. companies? The corollary to that is that if you allow foreign companies access to our markets with lesser disclosure, doesn't that give them an advantage? **[TI 3/17, p. 55]**

Participant I-16
What's the advantage? I would make the counterpoint that increasing disclosure increases efficiency and U.S. companies and the U.S. economy benefit from greater disclosure. To preclude people from doing something which they would choose to do, who benefits from that? Who benefits from a U.S. investor precluded from investing in a U.K. company? **[TI 3/17, p. 55]**

Committee/Staff/Observer
It may be an unsophisticated U.S. investor who invests in a lousy U.K. company? **[TI 3/17, p. 55]**

Participant I-11
I said public investor. If [a financial institution] wants to put money in the Argentine tunnel railroad, that's fine. **[TI 3/17, p. 55]**

Committee/Staff/Observer
Following from what [participant I-12] said, we are seeing that happen with non-U.S. companies going to the private placement market through rule 144A and so on. Now, the New York Stock Exchange is putting pressure to let companies like that register on their exchange. That's where we do get to the public investor. The real issue is whether you're going to drive the capital market more and more into a private environment as opposed to a public environment. **[TI 3/17, p. 55-56]**

Participant I-16
But if you don't, the sophisticated U.S. institution will invest in London in those same securities. You're not going to prevent them from investing; you're just going to make it happen some place else, and you'll have less control over what's going on. **[TI 3/17, p. 56]**

Participant I-12
Ten years ago, U.K. companies would come here and tell us how wonderful they are, and we analysts would promptly beat up on them, asking for the numbers. What has been happening over the last 10 years is that a lot of these companies are reporting more and more information, coming closer to our U.S. GAAP basis. And I think that's important that we hold up that standard. Another factor is that any U.S. company that is going to invest overseas on a private basis is going to go into that company and beat up on them just as much as analysts in the public markets do, and make sure that they know what they're doing. So there is an evolution taking place and there has to be some compromise. But I concur; [a financial institution] is going to invest wherever in the world we want to invest. That may force us to start investing overseas more than we invest here if that's where the better investments are. **[TI 3/17, p. 56]**

Participant I-5
I have a problem with [a financial institution] being able to invest wherever they want to invest, and they should be allowed to, but the small retail investor will not be allowed. Why can't they do that? Why not make U.S. GAAP optional? Otherwise, you have an inherently unfair system. **[TI 3/17, p. 56]**

Participant I-12
It is anyway. **[TI 3/17, p. 56]**

Participant I-5
Well, it's only getting worse. **[TI 3/17, p. 56]**

Participant I-12
There's a lot of rules that already prohibit selling certain deals to small investors. **[TI 3/17, p. 57]**

Participant I-5
Tons of them, but do we want more? Surely we haven't helped people avoid being sucked into frauds? You haven't stopped them from incurring losses because when [a financial institution] loses the money, I get taxed for it anyway. **[TI 3/17, p. 57]**

Participant I-12
Our markets are built on the concept of full disclosure. The SEC's view has been that they don't care if our 85 year-old aunt June invests in an oil & gas partnership so long as the risks and rewards of that are fully disclosed. If we're going to allow self-registrations, for example, in order to remain competitive as a capital market, then it would make a lot of sense to limit the coverage of who can invest in foreign companies not reporting under U.S. GAAP. If they want to be fully opened to the marketplace, then they can have a registered ADR or whatever, but they have to be fully disclosed just like a U.S. company. **[TI 3/17, p. 57]**

Participant I-5
And the only other choice in my opinion is to make GAAP optional to U.S. companies. **[TI 3/17, p. 57]**

Participant I-12
I'd love to see German companies report on a GAAP basis. I think we need to keep GAAP as a requirement. I'm a big believer in full disclosure. If you own a piece of paper, and you own a company, and you don't have any idea of what's going on because they don't tell you, you shouldn't be owning it. **[TI 3/17, p. 57]**

Participant I-7
I think it's easier getting what you want over a period of time by having the existing process rather than asking for it to be legislated. You can see that offshore companies are doing more and more conforming to our GAAP. **[TI 3/17, p. 57]**

Committee/Staff/Observer

I think the one conclusion we can make is that you were clear in saying that we should not change U.S. standards if it means lessening in any way to ease international harmonization. Do you agree? **[TI 3/17, p. 58]**

Group
Correct. **[TI 3/17, p. 58]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of OCBOA statements. During the discussion, comments were made on international harmonization of standards.

Committee/Staff/Observer
If you lend to a foreign company or evaluate a foreign company, will you feel the need for reconciliation to U.S. GAAP? [Also included in 14] **[TC 3/11, p. 37]**

Participant C-13
That comes later but the answer is yes. [Also included in 14] **[TC 3/11, p. 37]**

Participant C-5
On the issue of foreign corporates, we do a significant business with U.S. domiciled subsidiaries of foreign corporates and they prepare consolidated reporting in their home country, and we have typically accepted, for competitive reasons, management information using our own internal audit of that management information. We're using management-prepared information and doing our own audit standards against that. Also, we will accept tax returns. We weight them differently than we would a GAAP prepared statement but on the small end they are a workable document. Cash flow is a big component of it and a tax statement in many cases gives me more on cash flow than some of the GAAP reported statements do at the lower end. [Also included in 14] **[TC 3/11, p. 38]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of international harmonization of standards.

Committee/Staff/Observer
Question 14. To what extent do you use the financial statements of entities that are based on some foreign basis of accounting and what do you do when you run into that? And secondly, if there were a push to make that a more unified approach, where countries would essentially buy into a common set of standards, how would you view that if to do that U.S. GAAP was not the standard? And recognize that probably means since U.S. GAAP is one of the more stringent tests, that you would have to be seeing something less stringent in the future. So how would you feel about a common standard that would not necessarily be U.S. GAAP? **[TC 3/11, p. 57]**

Participant C-14

We have a couple of joint venture credit rating agencies in Mexico and Chile and Argentina. So we do some of this because we've been rating some companies like a [names deleted]. The problem was they've got some very important principles that we've viewed in the U.S. as not necessary with regard to inflation accounting. If we were going to go to a global set of principles, they'd have to incorporate inflation accounting which is something that doesn't necessarily have a big impact on the numbers here in the U.S. But generally speaking, when we do look at the companies in those countries, we like to evaluate them according to the accounting conventions that are practiced in that country because we compare them against other companies in that country to get a handle on their competitiveness. And then we do also compare them on a global basis in terms of how well they compete and then it's a matter of trying to make adjustments to make the numbers comparable. But we don't recast a Mexican company's numbers to be directly comparable with its U.S. competitors because there's too many aspects. There's foreign exchange issues, there's interest expense because of the high inflation. So I don't have the answers but I think that inflation is going to be one of the biggest issues we're going to face on this. **[TC 3/11, p. 57]**

Participant C-15
We also do a fair amount of business outside the U.S. What we try and do is to put companies on a comparable basis and not necessarily on a GAAP basis. For example, looking at non-U.S. financial institutions, a number of banks in the UK are able to revalue their fixed assets every five years to the current market value. And in the past it's been upwards. So when we're comparing [names deleted] to a U.S. bank, we would back that out. We would have comparable numbers. Internally we call it sort of [our company] GAAP. So it's not local accounting practices and it's not GAAP but it's something in the middle to at least make the comparisons meaningful. Because once you start to do cross-border type of analysis, you have to make some kinds of adjustments, otherwise because of the different accounting systems there's real big differences. **[TC 3/11, p. 58]**

Committee/Staff/Observer
Relate for me the cost benefits. I accept the idea that inflation may be an added chunk that we don't see right now in our accounting standards but if it was proposed that we have kind of common based accounting but the method by which you did that would depart from U.S. GAAP, how would you feel about that? **[TC 3/11, p. 58]**

Participant C-15
I could sort of live with it because I was in the international department, I dealt with that for fifteen years. I wouldn't have a problem with it. But having done that for fifteen years I also know it's never going to happen. **[TC 3/11, p. 58]**

Participant C-14
We've got to be moving in that direction over the longer term. It's probably not something that will result out of these meetings but it's all becoming globalized, the capital markets, and we have to start addressing those kinds of issues. The accounting's got to go to more global standardization. If that means we've got to introduce inflation accounting and change the way we account for goodwill to be more consistent with other countries or to make them more consistent with us, I think we have to go that way or at least maybe as a starting point introduce supplemental accounting disclosures for companies that have large international

presence. There's a lot of big U.S. companies that derive more than 50% of their earnings from abroad. So maybe we start to develop some small supplemental disclosures that helps us compare [one company] to [other companies] so that we can start to see some consistency in the numbers. **[TC 3/11, p. 58-59]**

Participant C-5
Probably 20% of our exposures are international. We use mostly local analysts as far as the work that goes into those. Decisions are made up to a certain dollar level locally. I sit on the committee that reviews all the large dollar exposures. We do not make an attempt to create a [name deleted] GAAP or any conversion of GAAP. We take them as done and we are expected to understand the differences in basic accounting practices between countries. Our country exposure committee would review and one of our items is to discuss accounting differences. But by using local analysts who start the initiation and really propose the credit, they've already somewhat summarized those in that local context. I wouldn't say the benefit is that tremendous to go to standardization over time. We're going to be there. It's a question whether it's 10 years or it's 40 years. **[TC 3/11, p. 59]**

Participant C-11
I just would agree with everything that's been said so far and amplify it by a comment on the IASC procedures as I have seen them so far. In many cases, they are accepting alternative methods so that I don't think we can say up to this point that real standards are yet emerging that are comparable or consistent. And to your question about what if we had something international that was different than GAAP, I think you have to ask questions about which aspects are different and in some cases, to use an extreme example such as the German approach of hiding everything, I don't think we could accept it. **[TC 3/11, p. 59]**

Participant C-13
There are two separate issues here. One is investors making investments in local currencies in foreign markets and there it seems to me what we do is we don't make any attempt to adjust those earnings to generally accepted accounting principles. We take them at face value. But then we look at how the local market, which is where the price is set, makes judgments about the values of those securities. The other aspect is a very different matter when foreign companies want to sell securities in the U.S. to U.S. investors. And our market is clearly attractive to them because a lot of them want to do it. I feel very strongly that the reason why it's attractive to them is that we've got the deepest and the fairest and the broadest markets in which investors have confidence in the integrity and the completeness and the accuracy of financial statements, i.e. U.S. GAAP. And I don't think that foreign companies should sell securities to U.S. investors in the U.S. without adjusting their numbers to U.S. GAAP for that reason. **[TC 3/11, p. 60]**

Participant C-14
That seems kind of myopic to me, though. **[TC 3/11, p. 60]**

Committee/Staff/Observer
For those who serve the mid-market, low market, if I were to tell you that we would start changing U.S. accounting principles because we need to harmonize them with foreign principles, does that bother you or not? **[TC 3/11, p. 60]**

Participant C-2
Assuming that it lowered the quality of information instead of raised it? **[TC 3/11, p. 60]**

Participant C-17
You'd have to retrain the entire organization. You've taken everybody away from their comfort level, from what they understand and know how to deal with; they are very provincial issues but they exist. **[TC 3/11, p. 60]**

Participant C-2
It depends on the perception of what it would do to the quality of the statements we receive. If the perception is that it would be lower quality, then you would have a big outcry. If the perception is it would improve the quality, then you would probably have small institutions lending into mid-market not concerned. And probably could be retrained without a lot of cost or disruption. **[TC 3/11, p. 61]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 18

a. Do you currently have to rely on financial reports prepared under accounting rules other than U.S. rules to make investment decisions?

YES *3*
NO *2*

If YES, please answer the following:

	YES	*NO*
1. Do you convert (at least partially) the non-U.S. accounting to U.S. GAAP if the investment is made via a foreign local market? *Participant I-9:* I don't do this but we do not buy foreign stocks unless somebody has made this conversion (i.e. underwriters, CPA, etc.)	*1*	*2*

	YES	*NO*
2. Do you convert (at least partially) the non-U.S. accounting to U.S. GAAP if the investment is made via U.S. markets?	*1*	*2*
3. Would you favor the use of one set of accounting standards by all foreign companies wishing to raise capital in the U.S?	*2*	
4. If one international set of accounting rules was established, would it be acceptable if those rules required less disclosure than current U.S. GAAP requires?		*3*
5. Would you accept a universal set of accounting rules if those rules changed the way U.S. accounting measures balance sheet and income statement accounts? *Participant I-9:* Only if U.S. standards are improved, not lowered.	*2*	
6. If one international set of accounting rules cannot be established, as a user would you find a reconciliation of certain foreign measurements, such as net earnings, to those measured under U.S. GAAP helpful? *Participant I-9:* U.S. GAAP is a must.	*3*	

Participant I-16: I would oppose any change which reduced the disclosure by U.S. companies. I hesitate to require foreign companies to use U.S. GAAP to participate in U.S. markets. They should be encouraged to do so, but banning foreign companies from U.S. markets will encourage U.S. investors to invest in foreign markets.

[PMQI 3/17, p. 32-33]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 18

a. Do you currently have to rely on financial reports prepared under accounting rules other than U.S. rules to make lending and credit decisions?

_9_ YES _4_ NO

Participant C-4: But rarely.

If YES, please answer the following:

YES NO

4 3 1. Do you convert (at least partially) the non-U.S. accounting to U.S. GAAP if the loan will be extended by a local lender and denominated in the local currency?

8 1 2. Do you convert (at least partially) the non-U.S. accounting to U.S. GAAP if the loan will be extended by a U. S. lender and denominated in U. S. dollars?

Participant C-4: Do a cash flow statement - FASB 95.

7 6 3. Would you favor the use of one set of accounting standards by all foreign companies wishing to raise capital in the U.S?

Participant C-15: No one would comply!

3 6 4. If one international set of accounting rules was established, would it be acceptable if those rules required less disclosure than current U.S. GAAP requires?

Participant C-14: Depends on the area of reporting.

Participant C-11: Depends on standards.

6 2 5. Would you accept a universal set of accounting rules if those rules changed the way U.S. accounting measures balance sheet and income statement accounts?

Participant C-11: Depends on standards.

Participant C-5: Depends how.

9 __ 6. If one international set of accounting rules cannot be established, as a user would you find a reconciliation of certain foreign measurements, such as net earnings, to those measured under U. S. GAAP helpful?

COMMENTS:

Participant C-14: This issue is much more important than the proportionate amount of time we have spend on it. There could be a special committee just on this.

Participant C-12: U.S. disclosure is the best in the world, and is a critical support for our large, successful capital markets. It would be a mistake to reduce our standards to accommodate foreign issuers, who come to our markets in part because their own markets are smaller - a logical result of their weaker disclosure.

Participant C-17: Time to time have to review foreign statements usually in conjunction with the extension of credit to a US subsidiary - often hard to evaluate.

Participant C-9: 4 - Assumes in U.S. we would still enjoy GAAP disclosures. **[PMQC 3/11, p. 30-31]**

[The AIMR Corporate Information] Committee [CIC] would like to see foreign-based companies adopt those disclosure standards expected of U.S. firms. **[AIMR/CIC92, p. 1]**

18(b). Impact of Litigation

[Context] Meeting of the Investor Discussion Group of January 13, 1993. Part of the meeting was devoted to the topic of value information. During the discussion, a comment was made on the impact of litigation.

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 4] **[TI 1/13, p. 16]**

[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, a comment was made on the potential impact of disclosing too much information about operating risks.

Participant I-11
If you set a very low materiality threshold, let's say 1%, don't you run the risk of having so much risk to disclose that people will tend to treat it as litigation protection and ignore it, and it becomes valueless? [Also included in 10(b)] **[TI 1/13, p. 53]**

[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, comments were made on the impact of litigation on auditor involvement.

Committee/Staff/Observer
[Participant I-16], how important is that liability insurance policy to you? [Also included in 17(a)] **[TI 3/17, p. 3]**

Participant I-16
I think it's very important. There has to be some accountability. I'm not in favor of lawsuits but unless somebody suggests another way to make auditors accountable, I think we have no choice. [Also included in 17(a)] **[TI 3/17, p. 3]**

Committee/Staff/Observer
Your affection for the liability is to put a burden of responsibility on the auditor as opposed to the ability to collect financial benefits? [Also included in 17(a)] **[TI 3/17, p. 3]**

Participant I-16
Yes. [Also included in 17(a)] **[TI 3/17, p. 3]**

Participant I-7

If there's a significant mistake on the part of the profession, then liability is called into action; there's a reason for it. The investor who has taken the statements as a basis for making an investment should benefit by that particular liability. [Also included in 17(a)] **[TI 3/17, p. 3]**

Participant I-16
And the liability has to be tempered by what was involved. Was this just not the greatest work in the world, which isn't a huge liability; nobody guarantees that they're perfect. If there was some kind of collusion, then the liability is quite clear. [Also included in 17(a)] **[TI 3/17, p. 4]**

Committee/Staff/Observer
I don't think anybody disagrees on the latter, criminal intent and things like that. [Also included in 17(a)] **[TI 3/17, p. 4]**

Participant I-16
But the standards of performance are subject to some sort of debate. [Also included in 17(a)] **[TI 3/17, p. 4]**

Participant I-7
Isn't there some debate on the RICO act relative to the profession? Wasn't there something recently indicating that the profession may not be subject to the RICO act? [Also included in 17(a)] **[TI 3/17, p. 4]**

Committee/Staff/Observer
There was a court case a week or 10 days ago that came down in favor of [name deleted] that said that RICO was intended to go after organized crime, not organized accountants, and that it just went too far in that case. Good plaintiffs counsel have used RICO for 10 years as a sword over the profession. This is the first major case that said that it doesn't apply. [Also included in 17(a)] **[TI 3/17, p. 4]**

Participant I-7
They have done it in our industry also. [Also included in 17(a)] **[TI 3/17, p. 4]**

Participant I-7
Our profession, certainly the sell-side, has the same independence problem. When given the choice of two directions, unless the liability issue is significantly raised, the auditor, like the analyst, will take the choice that is more favorable to management. [Also included in 17(a)] **[TI 3/17, p. 8]**

Participant I-16
If I were not aware of it previously, I would probably have lost my job 10 years ago. This is not meant to be disparaging, but my impression is that this is done by the auditor to protect himself from liability rather than to inform investors. At the point where the auditor puts that note in, it's so well known that it doesn't add anything to the basic knowledge that is in the public domain. [Also included in 17(c)] **[TI 3/17, p. 24]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of structure and process.

Committee/Staff/Observer
Question 14 deals with the impact of litigation on the quality of external reporting. On page 18 of the meeting materials, we give you arguments about why litigation has helped and has hurt external reporting. Our first question is: on balance, do you believe that the current litigation environment has a net beneficial or detrimental effect on the quality of external business reporting? Please separately address the quality and cost of audits of financial statements in answering. **[TI 3/17, p. 58]**

Participant I-16
Yes and no. The only way you promote quality is to reward quality and punish its absence. Unless somebody has another way of punishing malfeasance or poor performance, legal liability is the only one I can think of right now. **[TI 3/17, p. 58]**

Committee/Staff/Observer
Suppose we did find something, for example, a system that would take people out of the profession. **[TI 3/17, p. 58]**

Participant I-16
With the amount of damage that could be done before someone is taken out, I'm not sure that that would be enough. I think financial penalty has to be there. If you can think of a fair arbitration system that is not dominated by someone being judged, I'm willing to give that a shot. But I think there has to be some kind of sanction of a financial nature that keeps quality control upmost in the minds of the profession. As far as question (b), current litigation improves the quality but it has to raise the cost. The cost of litigation and the cost of insurance has to be passed through to those being audited. I think it's a price that theoretically is worth paying. I'm not defending the size of the awards but I think we need something. We're far from the ideal system but I don't think we can scrap it and not replace it with something. **[TI 3/17, p. 58-59]**

Committee/Staff/Observer
There is a vast difference between penalties and fines and punitive awards. **[TI 3/17, p. 59]**

Participant I-16
I have a hard time with using RICO for things that are clearly not criminal in intent; that should go by the wayside. Also, the size of some of the awards are ludicrous compared to what is being done. But having meaningful financial penalties doesn't strike me as being out of line and I can't think of anything else to insure quality. **[TI 3/17, p. 59]**

Participant I-7
I would second what [participant I-16] said. **[TI 3/17, p. 59]**

Committee/Staff/Observer
Some analogy is drawn from time to time between the NASD type of regulation versus what the professionals do; some system that would make more sense than trying to solve all the quality issues in the courts. **[TI 3/17, p. 59]**

Participant I-12
It's a dilemma. There is an impact on management and the operating decisions that they make coming out of this litigation environment which concerns me. In some respects, reasonable opportunities may be turned down for fear that management will be sued in the future for bad decisions. Every decision entails risks and this litigation environment is discouraging taking risks. **[TI 3/17, p. 59]**

Participant I-16
Risk means if we make the right decision, you're rewarded, if you make the wrong decision, you're penalized. That's the definition of risk. **[TI 3/17, p. 59]**

Committee/Staff/Observer
But the current litigation environment may change the dividing line for what's a reasonable risk. **[TI 3/17, p. 60]**

Participant I-16
But that's a different issue from saying that there should not be any legal liability for professionals. For better or worse, you are members of a profession that is legislated. If I am a publicly-owned company, I have to hire an independent auditor and the reason for the legal requirement is that you are presumed to have a certain level of expertise and objectivity. In return, you have to take on certain public responsibilities, which is liability. **[TI 3/17, p. 60]**

Committee/Staff/Observer
I don't think anyone disagrees with that. My question is what the penalty should be. Right now, it's all your capital, your home, your car, every asset you have. **[TI 3/17, p. 60]**

Participant I-16
We sympathise with the points you're making. **[TI 3/17, p. 60]**

Participant I-5
I haven't seen a place where the threat of litigation is chilling. **[TI 3/17, p. 60]**

Participant I-12
Banking, lending to real estate. Do you know what [one regulator] is doing to the accounting profession, to bank lenders? This has a chilling effect on any lender decisions. **[TI 3/17, p. 60]**

Participant I-16
Am I missing something? I read recently that fourth quarter earnings were at record levels for banks? **[TI 3/17, p. 60]**

Participant I-12

Yes, but it's not because of loans. Loans are down. **[TI 3/17, p. 60]**

Participant I-16
Secondly, somebody in the banking industry or the S&L industry did lose a lot of money, which implies that one of two things at least is true: there was a lot of incompetence or a lot of malfeasance. **[TI 3/17, p. 61]**

Participant I-12
There was a lot of incompetence. The point I'm making is that there is a chilling effect on current business decisions because of this litigation. **[TI 3/17, p. 61]**

Participant I-16
I don't think that has anything to do with litigation. The problem is when you give a government guarantee to people, it's very difficult to hold them accountable for what they do with public money. If you eliminate the fear of litigation, you're just giving people a blank check. **[TI 3/17, p. 61]**

Participant I-12
I'm not talking about eliminating the fear of litigation. The pendulum swings; for a long time, there was inadequate oversight and way too much incompetence. The pendulum has swung in the other direction. My observation is that there is a chilling effect that I can see in my work on fundamental operations. **[TI 3/17, p. 61]**

Committee/Staff/Observer
It has had a chilling effect on auditors; I know of many firms, maybe not the big 6 but hundreds of firms in the U.S., that have given up auditing public companies. I think it has had a chilling effect not only on the auditing profession but on business in general by having fewer choices and all the other public considerations that go along with that. **[TI 3/17, p. 61]**

Participant I-16
It's very difficult being in a situation where you get a relatively limited amount of money in fees for performing a service that can cause enormous harm to people if done incorrectly. That's the basic problem. To say that the award should be consistent with the fees misses the point; the amount of damage that you can do with an improper audit is a lot more than what your fees can conceivably be. Which is not to argue that it hasn't gone way too far on the other side. **[TI 3/17, p. 61-62]**

Committee/Staff/Observer
I still don't know if I have an answer to the question. The basic question was: does the litigation environment have a beneficial or detrimental effect currently on the quality of external business reporting? **[TI 3/17, p. 62]**

Participant I-16
I said yes. **[TI 3/17, p. 62]**

Participant I-5
Beneficial. **[TI 3/17, p. 62]**

Participant I-11
Detrimental. **[TI 3/17, p. 62]**

Participant I-12
Detrimental. **[TI 3/17, p. 62]**

Committee/Staff/Observer
Why detrimental? **[TI 3/17, p. 62]**

Participant I-11
Cost. I don't think anybody is talking about eliminating legal responsibility for auditors. We're talking about the recent trends in litigation where the plaintiff's bar chooses who to sue based on their net worth, and RICO. It has created an environment where auditors, investment bankers, lenders, and corporate management all make decisions not based on what their best business judgement is, but based on what is least likely to get them in a court of law. Anyone that doesn't see that is not looking too clearly. **[TI 3/17, p. 62]**

Participant I-16
I don't see it. **[TI 3/17, p. 63]**

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 2(d)] **[TI 3/17, p. 63]**

Committee/Staff/Observer
You're getting less as a result? [Also included in 2(d)] **[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 2(d)] **[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, a comment was made on the impact of litigation.

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), 1(d), and 12] **[TC 12/8, p. 72]**

[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 impact of litigation on auditors and auditing.

Committee/Staff/Observer
How many others see the world as [participant C-4] sees it [that is, one of the benefits of audits is the ability to sue the auditors]? [Also included in 17(a)] **[TC 3/11, p. 3]**

Participant C-5
I would say we're exactly the opposite. We have not pursued that avenue in any situation and it just doesn't even enter into our judgment. We're looking for more the assurances as to the practice and the procedures, and have never really looked at the depth of the pockets. So, I would take almost a contrasting view that it just doesn't even enter the thinking process. [Also included in 17(a)] **[TC 3/11, p. 3]**

Participant C-11
I think it's good to know that the auditors must be nervous about the fact that somebody might sue them, and use a little bit more diligence than they might otherwise do. So I think the auditors should feel a little nervous. That they'd better really get into the stuff or they might be sued. I think that is helpful. On the internal controls, I do think that there's some difficult areas that I would want to feel comfort about, as to what kind of examination really did take place. And I'm thinking of some of these huge off-balance sheet items, such as the foreign exchange contracts, hedging type things. I think it's an interesting avenue to think about. The standard audit letter does not give any feeling one way or another that the critical areas have been looked at in depth. [Also included in 17(a), 17(c), and 19] **[TC 3/11, p. 4]**

Participant C-4
Just one other point about the ability to sue auditors. We see that more as a club, and as a possible incentive for auditors. We, in a number of instances, find situations where a CPA may be reluctant to change from a review to an audit, because of some of their concerns. And that provides useful information for us in those instances. So, the real use is as a lever against the auditor. [Also included in 17(a)] **[TC 3/11, p. 5]**

Participant C-2
I wanted to raise a different issue in answer to this question, and that is in terms of what's the greatest disappointment. The issue of privity and the underlying implication that unless you are in privity with the accounting firm, you may not rely on the information contained in the

audit. When I was with a different bank, with a great number of banks in different states, we had a couple of banks in states where privity had to be established. And again, I want to tie on to the comments that have been made earlier: it is not a bank's intention necessarily to sue the accounting firm. However, you do always want to try to preserve your rights. And in those particular banks, we developed some credit policies to try to at least get the banks in privity with accounting firms but we had very little luck getting the accounting firms to return letters basically acknowledging that we were in receipt of the statements delivered by the customer, and could in fact rely on the information in the audits. I do feel that there should be some classes of statement users considered to be automatically in privity with the accounting firms. [Also included in 17(a)] **[TC 3/11, p. 16-17]**

Participant C-5
I believe that the fact that those areas [like MD&A] are not opined on is a risk mitigant for the auditor as opposed to a need for scope expansion. Quite frankly, the detail auditors get into in other stuff is no more severe than what they get into on the supplement and the MD&A type disclosures. It's just that whatever you can do to reduce that liability factor is the driver behind not making affirmative statements. Obviously as you move down the scale in the quality of the audit firm, some smaller and medium sized firms will clearly just disregard those sections and make their disclaimers and don't treat it. But in a Fortune 500 type company, I find it very difficult to believe that auditors don't take a sense of ownership and accountability, and probably charge for scope work associated with review of that activity, regardless of the opinion that's issued or the disclaimers. I also want to touch on section (e) in the meeting materials. For mid-size companies, I basically get a consolidated statement (holding company and operating subsidiary) without the detail as to operating subsidiary reporting and so forth. The only thing I guess that could get me over that without having to do a report on the individual operating company itself is to clarify the intercompany transactions which are awash in consolidated reporting. That at least would give me a better comfort level as to the integrity of the operating company financial statements, if I can at least eliminate some of the intercompany and the non-external transactions, and understand the depth of those and sort of the issues between them. [Also included in 17(b)] **[TC 3/11, p. 23-24]**

Participant C-12
Being more of a cynic than an idealist, I throw out the idea that advocating a less standardized approach, given the business and legal environments in which we all work and the realities of the marketplace, it's going to be difficult to say certain things, both in terms of what management will accept in terms of the business relationship and particularly in terms of what the lawyers are going to allow to be said. And I fear that in the end it's a good idea. What we get is boilerplate; we think we have information but what we have is boilerplate. [Also included in 10(d) and 17(c)] **[TC 3/11, p. 31-32]**

Committee/Staff/Observer
With that cynical view, then would you just advocate staying where we are? [Also included in 10(d) and 17(c)] **[TC 3/11, p. 32]**

Participant C-12

I would tend to, yes, because I think in the end if we try to broaden what we get, the lawyers and the business relationship is going to give us boilerplate. [Also included in 10(d) and 17(c)] **[TC 3/11, p. 32]**

Participant C-14
Why would it necessarily be boilerplate? Are you saying that every opinion would have the same three issues? Or that because of pressure from management they'd pick issues that aren't truly significant? [Also included in 10(d) and 17(c)] **[TC 3/11, p. 32]**

Participant C-12
I tend to think we'd get the three easy ones raised in a way that waters them down a lot. We've been through this with merger letters and we've seen them expanded greatly. But there's no additional information there. There's more stuff but there's no useful information in this greatly expanded letter. Because the lawyers get hold of it. [Also included in 10(d) and 17(c)] **[TC 3/11, p. 32]**

Participant C-17
It tends to violate the two things I hold dear. One is the independence issue and the other's the consistency. When you start trying to do the hit list for the year and you have some kind of predetermined format, it just becomes subject to all kinds of constraints from the legal end or boilerplate; it tends to have very little value when it comes out. [Also included in 10(d) and 17(c)] **[TC 3/11, p. 32]**

[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 and other matters related to structure and process.

Committee/Staff/Observer
Question 15. Fundamentally, the question talks about many sides of the litigation risk issue and it asks several different kinds of questions that are all basically: does the risk of litigation, either upon the preparer or the auditor, in some way interfere with the financial reporting process or does it enhance it? Now you could see that from the point of view of making auditors more nervous. You can also see that from the point of view of making MD&A more cautious. We're looking for some kind of sense of balance from you of where the litigation risk on the whole makes a difference in terms of the information you get from preparers and what you think auditors are doing as they're performing the service. **[TC 3/11, p. 61]**

Participant C-15
Maybe the information that we get would be better but we'll get less information over time. **[TC 3/11, p. 61]**

Committee/Staff/Observer
I think it's one of the concerns that people have. As users do you see that concern or is that basically somebody else's problem which is not having a lot of impact on you? **[TC 3/11, p. 61]**

Participant C-4
We see it as CPAs giving into client pressures. The whole question of independence is one of our concerns. As long as we can have some ability to go after inadequate audit procedures we feel we are actually getting better quality reports. It does drive up the cost but we think it's a necessary cost in the current account environment to ensure quality. **[TC 3/11, p. 61]**

Participant C-5
I realize the dilemma in what we get in that it 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 2(b)] **[TC 3/11, p. 62]**

Participant C-11
I think this is a necessary component. If there is any value to the audit, there has to be the ability to go to court if something has not been done properly. The issue is a broader social issue. We have huge problems with product liability and malpractice liability. Whereas in earlier years people could do outrageous things and never get sued, now it's clearly the other way. And up until now, Congress has not found a way to have reasonable limitations on reckless court proceedings. But I don't think you can avoid the liability question and should not. [Also included in 17(a)] **[TC 3/11, p. 62]**

Participant C-7
I have mixed emotions. The threat of litigation has made the accounting profession more quality conscious but I also see that the added cost that that's entailed has led to a lot of boilerplate coming into the financial reporting. And then the movement away from audited statements, in part because the accountants are coming back to the client saying this is what it's going to cost you for an audit now to protect us and so they're saying we don't want to bear that cost so step it back for us. I think there's a net loss in that respect. [Also included in 17(e)] **[TC 3/11, p. 62]**

Committee/Staff/Observer
I'd like to hear any comments you have as well about whether the risk of litigation you believe hampers management's talking in MD&A or financial statements or anyplace else? Or do you feel that that's not much of a pressure as far as getting information you need? **[TC 3/11, p. 62-63]**

Participant C-1
I don't think that's a real pressure for management. I think people would be hard pressed to find that you'd sued someone based on what they said in an annual report. You're more likely to find that maybe management said something at the time of issuance of a security than in an annual report or even a quarterly report. **[TC 3/11, p. 63]**

Participant C-15
I think that the threat of being sued might make management actually disclose more because I think [name deleted], if I'm not mistaken, was sued not by the public but by the SEC for not disclosing the impact that a change in their cruziero/dollar rate would have on their operations down in Brazil. So I think, because of that type of possibility companies would probably expand what they're saying in the MD&A section. **[TC 3/11, p. 63]**

Committee/Staff/Observer
Nobody has ever suggested nor would it be realistic to assume that there would be no threat of litigation and liability. **[TC 3/11, p. 63]**

Participant C-17
I think in everybody's mind it's a necessary tool to have. I perceive it as having an effect. I don't know what to do about it in terms of fairness and that sort of thing. **[TC 3/11, p. 63]**

Participant C-10
I would say that both for the auditor and for the user and for the preparer, I would view the threat of litigation as detrimental overall. **[TC 3/11, p. 63]**

Participant C-17
The lenders have their own concerns, just in terms of lender liability suits. I would find it difficult to argue that there aren't situations where perhaps it was appropriate but where do you cross over from appropriate to a weapon? It's really the same scenario reversed. **[TC 3/11, p. 63-64]**

Participant C-2
I think we've all had to learn how to do business a little differently because of the threat of litigation. And in some cases, there may have been a positive side to it. **[TC 3/11, p. 64]**

Committee/Staff/Observer
[Participant C-10], you obviously took a position that is different from what some have said and you're seeing it as detrimental; why? **[TC 3/11, p. 64]**

Participant C-10
It's causing overreaction on the part of the auditors and overreaction on the part of the managers. **[TC 3/11, p. 64]**

Participant C-17
When I think about it sometimes I wonder why isn't there a penalty, for instance? If you're a litigant, you're going to sue someone in any spectrum, business or personal. You have everything to gain and nothing to lose. **[TC 3/11, p. 64]**

Participant C-5

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 2(d) and 18(c)] **[TC 3/11, p. 65-66]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 19

Companies and their public accountants today face significant litigation related to their association with external financial reporting. All parties generally agree that companies and auditors should be responsible for their actions, and that legal remedies for misconduct are an appropriate and powerful inducement to professionals to adhere to proper standards of conduct. However, some believe that the current legal environment is seriously out of balance and results in unintended costs that exceed the benefits. They argue for certain reforms that they believe will restore balance. Those reforms include adopting a separate and proportional liability rule in place of the existing joint and several rule, shifting the prevailing party's attorneys' fees to the losing party, and permitting the incorporation of accounting firms. Others disagree that the existing system is out of balance. They believe that the existing principles and rules are necessary to provide the appropriate inducement to professionals, and to fairly compensate victims of misleading reporting for their losses.

a. What *positive effects* do you believe the current threat of litigation has on the auditors' work and/or on financial reporting? (Check *as many* boxes as are appropriate.)

1. It forces the auditors to increase the quantity of auditing tests and procedures.	*4*
2. It forces the auditors to elevate the quality of their work.	*5*
3. It forces companies to disclose more information about potential "downside" risks.	*2*
4. It forces companies to elevate the quality of their financial reports.	*3*

5. Other. Please describe:	*Participant I-9:* Most fraud that I have been involved with relateds to current assets or liabilities. Auditors must be accountable for certifying inventories, net receivables, reserves are appropriate.

b. What *negative effects* do you believe the current threat of litigation has on the auditors' work and/or on financial reporting? (Please check *as many* boxes as are appropriate)

1. It imposes unnecessary legal costs on companies and increases the costs of audits (costs which are ultimately borne by the users of financial reports).	*3*
2. It provides auditors with a disincentive to associate themselves with "riskier" clients (perhaps because of the nature of the client's industry or the client's financial condition at one point in time).	*1*
3. It reduces companies' willingness to experiment with new disclosures that could be helpful to users of financial reports.	*2*
4. It leads to a detailed "cookbook" approach to accounting that emphasizes strict "legalistic" compliance with detailed rules rather than focusing on broad reporting objectives that better reflects the economic substance of a company's business activities.	*3*
5. It creates an attitude toward financial reporting that encourages "over-conservatism" to protect the preparer and auditor.	*3*
6. Other. Please describe:	

c. On balance, do you believe that the current litigation environment has a net beneficial or detrimental effect on the quality and cost of *external financial reporting*?

BENEFICIAL *4*
DETRIMENTAL *1*

d. Do you believe that the current litigation environment has a net beneficial or detrimental effect on the quality and cost of *audits of financial statements*?

BENEFICIAL *3*
DETRIMENTAL *1*

Participant I-16: Incentives encourage better performance. For some, such as auditors, it is difficult to measure performance (absence of mistakes) and create incentives. It may be appropriate to pay substantial fees and impose sanctions for poor performance in the form of legal liability for mistakes. Joint and several liability is wrong and the English rule of loser paying all court costs would be appropriate.

COMMENTS *Participant I-9:* Auditors must use reasonable common sense as business in determining how far to go in an audit - i.e. check out invoices and inventories of a second-rate discounter in poor financial more than [names deleted]. This should not be unduly burdensome and this expense is one that shareholders would not object to.

[PMQI 3/17, p. 33-35]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 19

Companies and their public accountants today face significant litigation related to their association with external financial reporting. Some believe that the threat of litigation has a net positive effect on the auditors' work and on financial reporting in general, others believe it has a net negative effect.

a. What *positive effects* do you believe the threat of litigation has on the auditors' work and/or on financial reporting? (Check *as many* boxes as are appropriate)

<u>9</u> 1. It forces the auditors to increase the quantity of auditing tests and procedures.

<u>10</u> 2. It forces the auditors to elevate the quality of their work.

Participant C-11: It should, anyway.

<u>7</u> 3. It forces companies to disclose more information about potential "downside" risks.

<u>4</u> 4. It forces companies to elevate the quality of their financial reports.

<u>1</u> 5. Other. Please describe:

Participant C-12: It encourages auditors to consider the bigger picture (or to do a simple "reality check") e.g. 1) how is the [name deleted] able to lend enormous amounts on developmental real estate (a known high risk asset) without reporting much loan loss expense? 2) To the extent that audited financial statements are used to sell high-risk securities (i.e., capital debt) to unsophisticated investors (i.e., branch customers), should the auditors apply stricter standards (or more aggressive business judgment about the client)?

Participant C-4: The threat of litigation is essential to keep external accountants accountable!

b. What *negative effects* do you believe the threat of litigation has on the auditors' work and/or on financial reporting? (Please check *as many* boxes as are appropriate)

_3_ 1. It imposes unnecessary legal costs on companies and increases the costs of audits (costs which are ultimately borne by the users of financial reports).

_6_ 2. It provides auditors with a disincentive to associate themselves with "riskier" clients (perhaps because of the nature of the client's industry or the client's financial condition at one point in time).

Participant C-5: Where audits needed.

_4_ 3. It reduces companies' willingness to experiment with new disclosures that could be helpful to users of financial reports.

_6_ 4. It leads to a detailed "cookbook" approach to accounting that emphasizes strict "legalistic" compliance with detailed rules rather than focusing on broad reporting objectives that better reflects the economic substance of a company's business activities.

_4_ 5. It creates an attitude toward financial reporting that encourages "over-conservatism" to protect the preparer and auditor.

_2_ 6. Other. Please describe:

Participant C-4: Although it raises costs, every industry is faced with higher costs because of the threat of legal action. Why should CPAs be exempt? If anything, our entire legal system needs modification, particularly in the area of TORTS!

c. On balance, do you believe that the current litigation environment has a net beneficial or detrimental effect on the quality and cost of *external financial reporting*?

_7_ BENEFICIAL _5_ DETRIMENTAL

Participant C-4: Quality outweighs cost.

d. Do you believe that the current litigation environment has a net beneficial or detrimental effect on the quality and cost of *audits of financial statements*?

_7_ BENEFICIAL _5_ DETRIMENTAL

Comments:

Participant C-8: It has not been all bad.

Participant C-15: Regular semi-annual meetings with Task Force or one on one discussions by AICPA board members and creditors.

Participant C-12: This is a societal problem, not just an accounting problem.

Participant C-11: So far I have not heard auditors say that they are taking steps to improve the quality of auditing.

Participant C-21: Sometimes a correct is necessary; however, litigation continuing at its current level is now having a negative impact.
[PMQC 3/11, p. 31-33]

18(c). Resistance to Change

[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, 5(a), 8(c), 11(a), 12, 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), 4, 5(a), 8(c), 11(a), 12, and 18(d)] **[AIMR/FAPC92, p. 60]**

Those two paragraphs introduce the following summary of a position taken by the Committee.

> <u>Cost/Benefit Analysis from a User Viewpoint</u>
> 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 1(d)] **[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 1(d)] **[AIMR/FAPC92, p. 64]**
>
> 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 1(d)] **[AIMR/FAPC92, p. 64]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of structure and process.

Committee/Staff/Observer
. . . One last question in this area of resistance to change: assuming that you agree that the final recommendations of the Special Committee represent improvement in external reporting at acceptable cost, what channels could the Committee use to achieve broad-based support from investors for its recommendations? **[TI 3/17, p. 64]**

Participant I-12
My experience has been that we have all these organizations, the AIMR, the New York society, but from the viewpoint of analysts, the most potent arena comes through the splinter groups. All the banking analysts belong to a splinter group, the chemical analysts, the auto analysts, etc. **[TI 3/17, p. 65]**

Participant I-5
I agree. **[TI 3/17, p. 65]**

Participant I-7
There is one body and one body only 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 3(a)] **[TI 3/17, p. 65]**

Committee/Staff/Observer
The AIMR now has a report about changes in financial reporting and they've asked for comments from anybody, including analysts, by the end of this month. Do you have a feel as to whether or not any of the splinter groups will respond to the AIMR? Do they know about the report? **[TI 3/17, p. 65]**

Participant I-12
It's highly likely that that report is on my desk but I don't remember having seen it. **[TI 3/17, p. 65]**

Participant I-16
I think you're greatly overestimating what AIMR represents. AIMR is not like the AMA or the ABA; 99.9% of analysts couldn't care less about what the AIMR is doing. **[TI 3/17, p. 65]**

[Context] Meeting of the Creditor Discussion Group on March 11, 1993. Part of the meeting was devoted to the topic of structure and process.

Committee/Staff/Observer
Question 16. If the Special Committee is to make recommendations that they think represent improvements, particularly founded on things you have said to us, we need to have a better

understanding of how the world might receive those so we wouldn't encounter the same level of resistance that accompanies any suggestion for change. **[TC 3/11, p. 64]**

Committee/Staff/Observer
We have concluded as a committee that an important part of our process will be to not just study and make recommendations but to figure out what to do about those once they've been made, to make the likelihood of implementation greater and to, if possible, assure implementation. So we're looking at the process which you might characterize as a change management process and what we need to do to improve the prospects for changes once we get to the end of the road without at this point in time speculating about what the end of the road is. And so we would like to have your perspectives on where you see the hurdles, the resistance factors, what are we going to encounter, where will the resistance come from that we will inevitably encounter in this process? **[TC 3/11, p. 64-65]**

Participant C-17
I think the most obvious one is that we can outline an ideal world but it imposes cost. And especially in today's environment that will be very fiercely resisted. In addition to cost, whenever you're asking for more disclosure, there may be management resistance. **[TC 3/11, p. 65]**

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 2(d)] **[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 2(d) and 18(b)] **[TC 3/11, p. 65-66]**

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 2(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 2(c)] **[TC 3/11, p. 66]**

Participant C-11
I think if the information (the disclosure) is better than it's been, the user is certainly going to welcome it. The problem is that different situations may require different clarifying information. We talked today as well as in the past about the inventory questions and receivables aging questions. We've talked certainly about a quarterly and annual segment reporting needing to be better. You mentioned the problem of once you report something, it's therefore a permanent fixture and that's certainly what the preparers always say. I think the public and really the SEC has to do what they have said they do do and that's be flexible but I think they have not always done it. If a company reports something and it's useful at that time but it may not be needed in the future, not to require it is something. I think if they did what they said they want to do, and that is to provide a flexibility in terms of what gets reported, you would have a better environment for dealing with different situations that come along in different companies. That's definitely needed so that the preparers can be a little bit more comfortable. **[TC 3/11, p. 66-67]**

Committee/Staff/Observer
[Participant C-11], you mentioned that if the information is better, the users will welcome it and I think that's encouraging. Do you think that for users there will be a reasonably clear consensus about what is better? Or is it likely that we will find as much resistance on the user side of the equation as we do on the preparer side of the equation? **[TC 3/11, p. 67]**

Participant C-11
It would depend on the information. And what came to my mind is we're getting after the fact almost much better disclosure on the nature of where loan loss problems are in banks. I glanced at the new [name deleted] report yesterday and there's an incredible breakdown of where the real estate problems are for the first time. So users certainly are going to welcome that. At the same time, I think you will find users to have very negative feelings about some of the implications of the accounting changes that people are proposing. So I have to say it would depend on what's being proposed. **[TC 3/11, p. 67]**

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 2(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 2(c)] **[TC 3/11, p. 68]**

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 2(d)] **[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 2(c)] **[TC 3/11, p. 68]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 20

The Special Committee believes there could be resistance to effecting change in external financial reporting. Some of the sources of that resistance to change were briefly discussed at the meeting.

a. In your opinion, which of the following groups are most likely to resist change in financial reporting? For each suggested group, please indicate:

H High level of resistance
M Moderate level of resistance
L Low level of resistance

	High	*Moderate*	*Low*
Preparers of financial reports (management)	*2*	*1*	
Board of directors		*2*	
Creditors			*2*
Investors			*2*
Auditors			*2*
Standard setters			*1*
Regulators (including the SEC)			*2*
Others. Please specify: *Participant I-11:* Academics			

Comments *Participant I-16:* The amount of resistance depends upon the specifics of the changes.

Participant I-11: I think the level of resistance will vary according to whose ox is being gored - but generally I think it will be highest amont managements and lowest among users (at least if we are talking about changes that enhance disclosure). I suspect the strongest reactions pro and con will come from regulators and academics, who often have non-economic agendas in these matters.

[PMQI 3/17, p. 35-36]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 20

The Special Committee believes there could be resistance to affecting change in external financial reporting. Some of the sources of that resistance to change were briefly discussed at the meeting.

a. In your opinion, which of the following groups are most likely to resist change in financial reporting? For each suggested group, please indicate:

H **High level of resistance**
M **Moderate level of resistance**
L **Low level of resistance**

Participant C-5: Depends on direction and degree.

H-8,M-3
__ Preparers of financial reports (management)

H-3,M-6,L-2
__ Board of directors

Participant C-12: Should be low, but many are too close to management.

H-1,M-6,L-3
__ Creditors

H-1,M-4,L-5
__ Investors

H-4,M-4,L-2
__ Auditors

H-2,M-7,L-2
__ Standard setters

H-2,M-5,L-4
__ Regulators (including the SEC)

H-1
__ Others. Please specify:

Participant C-11: Bad question. Answer should depend on what changes are being proposed.

Participant C-5: Analysts.
[PMQC 3/11, p. 33-34]

18(d). Investor and Creditor Involvement in Setting Accounting Standards

[Context] The following brief summary of the topic "The Standard-Setting Process," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

> Several topics are covered in this section. First is our assertion of support for the continued development of globally acceptable accounting standards. That support is accompanied by a discussion of the problems that we expect will be encountered in the quest for worldwide standards. [Also included in 18 (a) and 18(e)] **[AIMR/FAPC92, p. x]**
>
> Second, we express our support for the standard-setting process in the United States and for the FASB as an institution. We provide refutation to many of the criticisms directed against it. We do not believe the FASB is to blame for many of the complications in financial statements today, nor do we believe that it has issued too many standards too quickly. We disagree with those who say its standards are too theoretical, that the cost of implementing them is too great, or that the FASB is inimical to the interests of financial statement preparers. Rather than following due process too little, we believe the FASB follows it too much. The reasons supporting these beliefs are set forth in the report. [Also included in 18 (a) and 18(e)] **[AIMR/FAPC92, p. x]**
>
> Finally, we emphasize the needs of financial statement users in the standards-setting process. We argue that users of financial statements are also the owners of the enterprises being reported upon, and it is the users who, in addition to receiving the benefits, ultimately bear the cost of providing financial reports. We suggest that user viewpoints be incorporated in the standard-setting process through their direct participation as members of the FASB, in addition to the current practice of their providing written comments and oral testimony. [Also included in 18 (a) and 18(e)] **[AIMR/FAPC92, p. x]**

[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.

> <u>A Note on Field Testing</u>
> AIMR's Financial Accounting Policy Committee has on several occasions communicated directly to the FASB its support of field testing in the standards-setting process. Field tests can be enormously helpful in identifying implementation problems that neither preparers nor users of financial statements could have anticipated at the conceptual level. We commend those enterprises and their auditors who have volunteered their time, funds, and effort to test proposed standards in the past and we encourage others to participate in the future. **[AIMR/FAPC92, p. 51]**
>
> AIMR also is enthusiastic about the prospect of financial analysts participating in field tests. We believe that we could add a heretofore absent dimension. To date, field tests have concentrated on the feasibility of preparer implementation of proposed new accounting methods. Analysts would be able to comment on the value of the information generated by

those methods. They could also recommend the forms of presentation that would best serve effective dissemination of the information contained in the data. Specifically, they could provide expert opinion as to how well the new methods create knowledge that is useful to the process of valuation. **[AIMR/FAPC92, p. 51]**

If investment professionals were to participate in field tests, safeguards would be needed to protect the confidentiality of the information being generated. The first of these is Section II. C. of the AIMR Code of Ethics.20 Only AIMR members who would not find field test information useful in their trading or related activities could participate. Eligible testers would include a variety of working analysts as well as other AIMR members, such as academics and others not currently or directly participating in capital market transactions. Additionally, there are undoubtedly many circumstances in which additional practicing analysts could participate without having to know the identity of individual field test firms or (sometimes) their industry affiliation. Finally, there would have to be ways to assure the business enterprises participating in field tests that the safeguards were operative and effective. **[AIMR/FAPC92, p. 51]**

AIMR has long been an active participant in the standard-setting process, both in the United States and internationally. It has presented its views in writing and in testimony more frequently than any other organization of financial statement users. Frank Block, long-time member and former chairman of the Financial Accounting Policy Committee (FAPC), served a term as FASB board member. Patricia McConnell, current chairman of the FAPC, is a member both of the Board of the International Accounting Standards Committee and the Financial Accounting Standards Advisory Committee (FASAC) that advises the FASB on matters it has currently and prospectively under consideration. Gerald I. White, former long-time chairman of the FAPC, serves on the IASC Advisory Board as well as frequently presenting the views of and serving as spokesman for financial analysts on financial reporting matters. George H. Boyd III of Kidder, Peabody & Co. currently occupies the "financial analyst chair" as a trustee of the Financial Accounting Foundation, the organization that sponsors and supports the FASB. Financial analysts almost always are represented on task forces organized by the FASB to prepare discussion documents on agenda items. Financial analysts from the United States frequently have served on IASC steering committees (similar to FASB task forces). **[AIMR/FAPC92, p. 51-52]**

With the exception of the one full-time FASB member, all individual analysts cited above serve as volunteers and render their services to the standard-setting process in addition to, not as part of their regular work as analysts, money managers, research directors, academics, etc. Their dedication is commendable. Furthermore, they have the task of representing, with both time and funding in meager supply, the majority of professional users of financial statements. Their views deserve to be heard, even though they are outnumbered and outspent by the legions of business firms, industry and business policy associations, large auditing firms, and professional associations of accountants, many of which have full-time paid staffs to research and advocate their views on financial reporting matters. . . . **[AIMR/FAPC92, p. 52]**

Need for User Viewpoints in Standard-Setting Bodies

Only once has the Financial Accounting Foundation appointed to the FASB an individual from the community of professional financial statement users. Even then, he was one of the few

FASB board members who served only one term. By contrast, the International Accounting Standards Committee includes two financial analysts as members of the board and several others on its advisory committee and various steering committees. As a result, financial analysts and investment managers often feel alienated from the standard-setting process in the United States, "the beggar at the feast" as one prominent investment manager stated.[23] We observe FASB members being selected from the ranks of auditing firms, business enterprises, academia, and government. Every realm, save one, seems to provide board members. **[AIMR/FAPC92, p. 54-55]**

Most practicing financial analysts are neither accounting technicians nor theorists. They do not have the time, given the demands of their work and the limited (but vital) role financial reporting plays in it. Some might say that is a reason not to appoint a financial analyst to the FASB. But it is more a reason to make such a selection. First, we must keep in mind that the primary purpose of financial reporting is to provide information that is valuable to financial statement users; it is not merely to produce reports that comply with a variety of arcane requirements nor to provide employment to accountants. Therefore, those who use financial statements should have a major voice in determining their form and content. **[AIMR/FAPC92, p. 55]**

Second, financial statement users have perhaps the paltriest resources with which to lobby the FASB or otherwise present their views. As we point out above, we feel badly outspent and outnumbered in the "due process" activities of the FASB. The effort that we do expend is with the goodwill and forbearance of generally demanding employers and is dependent on the willingness of individual investment professionals to relinquish a certain amount of their personal or leisure time to further the interests of their fellows. **[AIMR/FAPC92, p. 55]**

Third, there is compelling need for at least one member of the FASB to provide a point of view that is totally absent from the board's inner workings now. We are well aware that board members are required to sever all ties with their previous employers and that members are to act in the interests of the board's entire constituency, not as representatives of special interest groups. An investment professional appointed to the board also would have to adhere to those terms and we would expect no less. Still, all persons are the sum of their experiences. It is baffling to us that the Financial Accounting Foundation allows the FASB to carry on year after year missing the background and experience of at least one financial statement user. We cannot imagine anything more pertinent or germane to the Board as it strives to fulfill its mission and put into practice the tenets of its conceptual framework. **[AIMR/FAPC92, p. 55]**

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

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[23] Gerald I. White. "The Coming Deregulation of Accounting Principles", published in *Financial Reporting and Standard Setting*, Gary John Previts, Ed. (New York: American Institute of Certified Public Accountants) 1991, p. 35.

spoken often and forthrightly in presenting our views and those of our predecessor association, the Financial Analysts Federation. [Also included in 1(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 1(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 1(d)] **[AIMR/FAPC92, p. 60]**

[Context] Meeting of the Investor Discussion Group on March 17, 1993. Part of the meeting was devoted to the topic of structure and process.

Committee/Staff/Observer
Question 15 deals with barriers to improving external reporting. Why are investors not more actively involved in the process of setting accounting and disclosure standards? The meeting materials offered some possible reasons. **[TI 3/17, p. 63]**

Participant I-16
Lack of expertise relative to the profession and internal financial executives, lack of resources compared to internal financial people, and less at stake than internal financial people. **[TI 3/17, p. 63]**

Participant I-12
As analysts, we take the statements as given. We're relying on these statements because our primary interest is the future. It's only been over the last decade or so that we've begun to wake up to the fact that we might be able to have some kind of impact. Very few of my

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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.

colleagues are aware that this Special Committee is in existence and operating. **[TI 3/17, p. 63]**

Committee/Staff/Observer
Yet for years the AIMR has sponsored the annual evaluation of corporate reports, taking hundreds of analysts thousands of hours to participate in that effort, which is solely directed toward improving external financial reporting. **[TI 3/17, p. 64]**

Participant I-12
That's right. I know that the AIMR has a relationship with the accounting profession and the FASB. But the groundswell that it takes from analysts just hasn't been there; I suspect it's partly because we have so many demands on our time. The AIMR research is done in the context that the accounting principles can't be changed, that they are predetermined. The focus is getting companies to give us more in terms of sense and feel. **[TI 3/17, p. 64]**

Participant I-16
The profession that we represent is not really after goodness and truth. The objective of [my firm] is to beat [the other firm]. We're in a relative performance game. If I'm one of five managers on an account and I come in second, I'm going to have that account next year; if I'm first I'm going to get some more money; if I'm fifth, I'll lose the account. Whatever the rules of the game are, as long as it's a level playing field, it's O.K. It's not my major concern; my major concern is spending my time to beat their brains out. **[TI 3/17, p. 64]**

Participant I-5
An analyst is supposed to be looking and watching what is happening, not influencing events, but interpreting those events. An analyst's job is not to make things happened. **[TI 3/17, p. 64]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 20

b. Why are most investors and other users of external reporting not actively involved in the process of setting accounting standards and, thus, in the process of improving external reporting? Is it because users (please mark *as many* choices as are appropriate):

1.Have a vested interest in maintaining the status quo so as not to change the nature or the relevance of their functions?	
2. Feel uncomfortable discussing technical accounting with standard setters because many users are not accountants?	*3*

3. Feel that the standard setters do not listen to the views of users?	*1*
4. Believe that certain trade organizations, such as the AIMR and the RMA, adequately represent their interests?	*1*
5. Something else. Please describe:	*Participant I-9:* We do not get paid to do it. We rely on and expect auditors to do this for us.

c. What channels could the Special Committee use to achieve broad-based support from investors for its recommendations?

Participant I-9: Give illustrations of how recommendations would have prevented investment fiascos- i.e. [names deleted] years ago, etc.
Participant I-11: I think these discussion groups provided an excellent forum for communication between the profession and the user community. Perhaps "standing" groups or future ad hoc groups could help. Perhaps, too, these groups provided a foundation for future "networking" between the accounting profession and the user community. (One Special Committee member commented to me that the Committee discovered its members discovered they'd had little contact with financial analysts. The reverse is true as well. For my part, I now feel I know several of the Committee and staff well enough to call with a question, comment, or problem. Perhaps the most valuable result of these meetings is the creation of those sorts of relationships - and perhaps the most important objective should be to reinforce and extend them.)
[PMQI 3/17, p. 36-37]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 20

b. Why are most creditors and other users of external reporting not actively involved in the process of setting accounting standards and, thus, in the process of improving external reporting? Is it because users (please mark *as many* choices as are appropriate):

__2__ 1. Have a vested interest in maintaining the status quo so as not to change the nature for the relevance of their functions?

__9__ 2. Feel uncomfortable discussing technical accounting with standard setters because many users are not accountants?

__4__ 3. Feel that the standard setters do not listen to the views of users?

3 4. Believe that certain trade organizations, such as the AIMR and the RMA, adequately represent their interests?

4 5. Something Else.
Please Describe:

Participant C-13: Time pressures are such that, though important, these concerns assert a lower priority than the press of day-to-day activities.

Participant C-12: (A) Takes too much time, and I don't know how. (B) Many user organization share too many constituencies to agree, e.g., we have analysts in 1) Credit, 2) Corporate Bond Research, 3) Equity Research, 4) Corporate Finance, and 5) sales and trading. There's no way to reach a consensus for a "[investment banker] view".

Participant C-5: Not organized, sufficiently with completely common interests (silent majority).

Participant C-17: Are rarely asked or perhaps informed of involvement of special interest groups such as RMA.

Participant C-9: Unaware of opportunity for dialogue.

c. What channels could the Special Committee use to achieve broad-based support from creditors for its recommendations?

Participant C-8: With respect to the surety industry, we would recommend trying to build support through invoking our trade associates:

Surety Associates of America
100 Wood Avenue South
Isalin, New Jersey 08830-0424
Floyd Provast - President

Participant C-13: As many as can be devised!

- Outreach to user groups - forums, seminars, etc.
- Achieve widespread popular business press coverage.
- Identify industry leaders who agree with the committee's recommendations, and solicit their support, etc.

Participant C-14: Publish the results of these meetings with names and organizations of participants to show that the ideas come from practitioners. Include a response form. Do a road show. Include volunteers (I would go) - on a tour of a dozen or so cities to hold seminars on needed changes and solicit support. Invite preparers/auditors/creditors, etc.

Participant C-12: Extend the current Discussion Group. Modify/simplify this type questionnaire for the broadest possible audience. Start with the top 100 banks, top 100 insurance companies, top 100 fund managers, etc. By maintaining a list of respondents over time, you could develop an efficient means of obtaining widespread feedback/participation.

Participant C-11: The Special Committee is the first thorough attempt by the AICPA to actually listen to users, and to understand how they use statements. The fact that this wasn't done before has carried the barrier between users and accountants to be present, and the resulting lack of a common language of communications or trust. Do more of this - as much as you can - even after the Committee report is done.

Participant C-5: User group forums.

Participant C-4: Industry association endorsements - CFMA - SAA - FMA - other. Do survey of users to provide support, release results to AICPA, assoc., etc.

Participant C-17: AICPA could set up a standing Creditor group representative of the industry to it can review and prepare recommendations.

Participant C-9: Distribute "Requests for Comments" to key industry groups and practitioners to elicit response.
[PMQC 3/11, p. 35-36]

[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 1(a)] **[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 1(a)] **[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 has 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 1(a)] **[R.G. ASSOCIATES, p. 2]**

Pretend for a moment that the AIMR does not exist. . . . How would the FASB go about getting input from the analyst community? If [the FASB] think[s] this way, [the Board] might discover new ways of gathering analysts' opinions. **[R.G. ASSOCIATES, p. 2]**

If memory serves correctly, there is a directory of investment firm research directors published by *Money Market Directories*, out of Charlottesville, VA. [I]t contains the names and addresses of about 400 directors of research - both buy-side and sell-side. If they were approached properly, they would probably delegate an appropriate analyst to provide . . . user input. What would be the incremental cost of obtaining this directory and sending Statement exposure drafts on a continuing basis to these user types, along with a letter soliciting their views? . . . [T]his would be a fairly cheap way of getting a broader range of analyst views. **[R.G. ASSOCIATES, p. 2]**

[The FASB] can't rely on the AIMR to represent the entire analytical community; if the AIMR didn't exist, ways to obtain analyst input could be found. . . . It's unfortunate that the user community won't step up and provide it on its own. The Board should recognize that the situation won't change without taking some steps of its own. . . . Look at the involvement displayed by the public accounting profession; it runs the gamut from small firms to international firms and it is influenced by their clients as well. . . . [I]f the Board desires this kind of involvement depth on the user side; unfortunately, it must be cultivated. . . . [I]t can be done successfully, though, and at a minimal cost. It might even enhance the performance of the technical staff by exposing them to more points of view. **[R.G. ASSOCIATES, p. 2]**

In the end, much of what the Board decides is based on judgment. As you point out, the answer that might please the largest number who choose to write on a particular project won't always be consistent with your mission. I don't think you would be running much of this risk even if you were wildly successful in harvesting greater analyst feedback. However, in any endeavor that involves judgment, better information should result in better decisions. **[R.G. ASSOCIATES, p. 3]**

Finally, when asked to assess these nine steps in the due process procedure, an incredibly high 87-8% majority of all groups rates the way the FASB handles the process as positive, sharply up from a comparable 59-6% five years ago, when a high 35% found themselves unable to make a judgment about the way the FASB was operating under its rules of procedure.

18.2.

Table 3.9

THOROUGHNESS IN OBTAINING INFORMATION AND ANALYZING ISSUES

Q 11C—On the matter of thoroughness in obtaining information and in analyzing issues, how would you rate the way the FASB handles this part of its due process?

	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Excellent	39	36	37	15	46	44	33	47	67	27	47	32	68	47
Pretty good	47	55	54	67	43	44	46	36	27	33	47	48	26	41
Not so good	7	8	6	9	4	5	3	11	–	27	7	13	5	6
Poor	1	1	3	–	–	–	2	2	7	–	–	–	–	–
Not sure	5	–	–	9	7	7	16	4	–	13	–	6	–	6
————Positive	87	91	91	82	89	88	79	82	93	60	93	81	95	88
————Negative	8	9	9	9	4	5	5	13	7	27	7	13	5	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *It is also evident that, in this case, greater familiarity has engendered a much deeper seated respect for, and adherence to, the way the rules are working out.*

[HARRIS]

18(e). FASB

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]**

- Financial statements and the related disclosures are too complex for most users (including analysts) to understand. As a result, there is a high cost to the preparer to produce financial information and a high cost to the user to analyze and understand the information. **[FASOversight, p. 1]**

- Business practices and transactions have become so complex that it is almost impossible to capture everything in the financial statements. **[FASOversight, p. 1]**

- There is inconsistency among industries and enterprises in the methodology for calculating reserves, allowances and other valuation adjustments. **[FASOversight, p. 1]**

- Financial reporting has not kept pace with the economics of business; for example, financial statements do not reflect the evolution from a manufacturing to a service economy. **[FASOversight, p. 1]**

- From an acquisition perspective, the financial statements do not reflect the value of an enterprise; the financial statements are of little value in evaluating acquisition opportunities. **[FASOversight, p. 1]**

Over the years RMA's Accounting Policy Committee (APC) has reached many important conclusions on accounting and auditing matters that reflect the viewpoints of lenders. These conclusions, reflecting as they do the views of financial statement users, are not all in agreement with current accounting and auditing standards. They are used to guide the APC in forming its comments and other responses to initiatives of the Financial Accounting Standards Board (FASB), Governmental Accounting Standards Board (GASB), American Institute of Certified Public Accountants (AICPA), Securities and Exchange Commission (SEC), International Accounting Standards Committee (IASC), and other designated standard-setting bodies. **[RMA90, p. 1-2]**

Understandability is an important characteristic of accounting data. The [following item] listed below [is] vital to understandability. **[RMA90, p. 3]**

- Standards, not rules: Financial accounting standards should address issues of broad principles. They should be less concerned with setting detailed rules, although interpretive guidance and examples illustrating implementation are desirable. **[RMA90, p. 3]**

[Context] The following brief summary of the topic "The Standard-Setting Process," is from the "Executive Summary" of the report the AIMR's Financial Accounting Policy Committee (FAPC):

Several topics are covered in this section. First is our assertion of support for the continued development of globally acceptable accounting standards. That support is accompanied by a discussion of the problems that we expect will be encountered in the quest for worldwide standards. [Also included in 18 (a) and 18(d)] **[AIMR/FAPC92, p. x]**

Second, we express our support for the standard-setting process in the United States and for the FASB as an institution. We provide refutation to many of the criticisms directed against it. We do not believe the FASB is to blame for many of the complications in financial statements today, nor do we believe that it has issued too many standards too quickly. We disagree with those who say its standards are too theoretical, that the cost of implementing them is too great, or that the FASB is inimical to the interests of financial statement preparers. Rather than following due process too little, we believe the FASB follows it too much. The reasons supporting these beliefs are set forth in the report. [Also included in 18 (a) and 18(d)] **[AIMR/FAPC92, p. x]**

Finally, we emphasize the needs of financial statement users in the standards-setting process. We argue that users of financial statements are also the owners of the enterprises being reported upon, and it is the users who, in addition to receiving the benefits, ultimately bear the cost of providing financial reports. We suggest that user viewpoints be incorporated in the standard-setting process through their direct participation as members of the FASB, in addition to the current practice of their providing written comments and oral testimony. [Also included in 18 (a) and 18(d)] **[AIMR/FAPC92, p. x]**

[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.

The Role of the FASB
We do not know what the future role of the FASB will be, but at the moment it certainly is the paramount standard-setting organization affecting financial analysis in the United States. Over the years we have had differences with the FASB and we have discussed many of them and noted others at various places in this report. Those differences are inevitable given our single-mindedness in seeking information useful in the workings of investment analysis. They in no way subvert our total support of the FASB as an institution. We are on the record[22] in that

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[22] See Appendix A, specifically letters dated April 8, 1991, and February 2, 1990.

regard. All of our comments herein are made with the hope of improving its operations, strengthening its perseverance, and raising its stature. **[AIMR/FAPC92, p. 54]**

From time to time the FASB is criticized, disparaged, assailed, censured, and even castigated by various individuals and organizations. Much of that criticism seems to us unwarranted, as we discuss in greater detail below. It seems to be as much an expression of disappointment and disagreement, ie. unhappiness, as anything else. In fact, the more we hear of it the more convinced we are that the FASB is accomplishing its mission. It has undertaken some of the most daunting projects imaginable: financial instruments, post-retirement benefits of all sorts, reporting income taxes, among others. It has been lobbied incessantly by, among others, the Business Roundtable, various competing government agencies, a variety of financial institution trade associations, and various trade associations and similar groups. **[AIMR/FAPC92, p. 54]**

Perhaps the best way to appreciate the virtue of the FASB is to ask who or what could do a better job. The answer is clear. There is no alternate arrangement that would come close to achieving the integrity of the FASB and its ability, by promulgating accounting standards, to compel the propagation of unpopular truth through financial reports. We, in common with others, could hope for standards more beneficial to our needs. Unlike many others, we also encourage the FASB to act more rapidly in considering and issuing standards. We have consistently opposed changes in the Board's operating procedures that act to slow its tempo. We hope it is clear that our position is one of thorough support for the institution, without endorsement of all its actions or conduct. **[AIMR/FAPC92, p. 54]**

Recent Criticism of the FASB

The issuance inate 1987 by the FASB of three majopronouncements marked the escalation of previously scattered protests into more serious dissention. "FASB bashing" became close to sport in some quarters. We agree with some of the opposition, but we differ with the passion (and sometimes vitriol) with which a good deal of it has been expressed. In most cases however, we believe that the FASB's critics either are mistaken or else are acting in a self-interested manner. Some of the criticisms we have heard and our answers to them are summarized in the list that follows. **[AIMR/FAPC92, p. 55-56]**

Financial reports have become difficult to understand. We agree, but for quite different reasons. First, business activity has become more complex. Second, the FASB has had the fortitude to confront difficult problems that are not amenable to simplistic answers. We do not expect the financial affairs of multifarious economic organisms to be reducible to a few simple comprehensive easy-to-read numbers. It just is not possible. **[AIMR/FAPC92, p. 56]**

However, we could and do expect a better effort on the part of enterprises issuing financial reports to make their affairs more understandable to the investment analysts and advisors who simply are unable to devote major portions of their time to digesting imposing new pronouncements on abstruse accounting topics. Financial reports more and more have taken on the appearance of compliance documents rather than communication tools. There is no need for that. Some investment analysts have even begun to question whether those who prepare financial reports understand the purpose for which a particular standard was issued. The FASB and the SEC set minimum disclosure requirements. There is no proscription on relating more or explaining that which is disclosed. We should not blame the FASB because it cannot mandate a willingness on the part of managements to decipher and illuminate their affairs. **[AIMR/FAPC92, p. 56]**

The FASB has issued too many standards too quickly. The FASB commenced operations in 1973, nineteen years before this report was written. In that interval, it has issued 109 standards and substantially fewer interpretations. The rate is fewer than six standards per year. But, the rate of issuance of major new standards with broad impact across all industries is between one and two a year. The vast majority of the FASB's new standards are modifications of existing pronouncements, adoption as standards of existing AICPA literature, or matters that affect specific industries, including not-for-profit enterprises. Not only that, the standards themselves are relatively brief. Most of the bulk is supplied by the included illustrations and practice guides requested by financial statement preparers and their auditors. **[AIMR/FAPC92, p. 56]**

Nor can the pace at which major new broad-based standards are issued be characterized as swift. In our comments on transition we remark on the number of years it takes before a new standard is fully implemented. In addition, many new standards take numerous years from the time they are placed on the FASB's agenda until a final standard is approved by a minimum 5-2 vote, the so-called "super majority." The change a few years ago from a simple majority vote for approval of a new standard to the "super majority" was designed to slow further the board's already glacial pace. **[AIMR/FAPC92, p. 56]**

Complaints about too many standards, too quick standards, or too-complex standards seem to be mistaken, but may actually be misdirected. Major new standards are infrequent and, shorn of accompanying material, relatively succinct. However, the numbers and size of the new reading material emanating from the FASB is overwhelming. Most of it pertains to matters in progress. Perhaps if the process were to be speeded up, fewer interim reports of various sorts would be produced, thus lessening the seemingly endless pondering by all of unfinished agenda matters. **[AIMR/FAPC92, p. 56]**

The FASB is too theoretical. This argument is heard frequently, but simply is not true. In fact, in many cases the FASB has issued standards that are obviously contrary to good accounting theory. For example: **[AIMR/FAPC92, p. 57]**

- FAS 87 and FAS 106 on employers' accounting for pensions and other postretirement benefits, respectively, contain a variety of procedures and choices that allow smoothing of transition balances, actuarial and experience gains and losses, and the cost (benefit) of plan amendments over many accounting periods, thus smoothing the annual pension costs in ways totally unsupported by accounting theory. **[AIMR/FAPC92, p. 57]**

- FAS 15 specifies accounting for restructured debt using methods that ignore the time value of money. FAS 15 directly conflicts with APBO 21 "Interest on Receivables and Payables." One of its effects was to allow financial institutions in the U.S. two different accounting results for optional alternative settlements of the Mexican debt, even though the alternatives were identical in substance. **[AIMR/FAPC92, p. 57]**

- FAS 52 provides that assets and liabilities expressed in foreign currency, where the local currency is the functional currency, shall be translated at the exchange rate at the balance sheet date. The result is that real assets (property, inventories, etc.) are treated as if they are money. In order to prevent obviously absurd results, FAS 52 prohibits application of that method to currencies of highly-inflationary[24] economies. **[AIMR/FAPC92, p. 57]**

In our opinion, a more accurate accusation would be that the FASB is not sufficiently theoretical in its pronouncements. We often are disappointed by the issuance of a standard that incorporates one or more flagrant departures from theory in order seemingly to make it more palatable to other members of the business community. Each departure from theory makes the data contained in financial statements less interpretable, or comprehendible only with additional analytic effort. **[AIMR/FAPC92, p. 57]**

It is quite possible that those who denounce the FASB for being too theoretical are in actuality complaining less about the standards issued than about the succession of documents that antedate issuance of a standard. Commentators are forced by discussion memoranda, invitations to comment, exposure drafts and the like, to provide conceptually valid support for the positions they take. Respondents therefore are required to be more than familiar with the FASB's conceptual framework project as well as with the greater body of "common law" accounting and economic theory. In addition, they are called upon to be up-to-date on new and seminal conceptual and empirical work, not only in accounting, but also in finance and economics. Although their grievances are filed with the FASB, they might be more accurately directed to persons who are pushing back the frontiers of knowledge. **[AIMR/FAPC92, p. 57]**

The cost of applying new standards is excessive. The dictionary definition of excessive is "characterized by excess; being too much or too great; immoderate; inordinate." For something to be excessive, it must exceed the right, proper or correct amount. Yet, there is no reference amount of cost that one can characterize or measure out as being correct. In short, excessiveness is a value judgement. Assertions that it exists do not make it true. **[AIMR/FAPC92, p. 58]**

In particular, it is the providers of financial statements from whom the claim of excessive cost is heard. We can respond by asserting that the cost to them, high as it may seem, is still less than the benefit to financial statement users of: (a) minimizing the cost of providing the data by having the firm do it once and provide it to multitudes of users who otherwise would individually have to replicate the firm's effort; (b) having the firm as the source of information, thus obviating the need for analysts to scavenge for less reliable data from secondary sources; and (c) making available an additional source of information which confirms or denies other sources. One of the charges to the FASB in its mission statement is: "To promulgate standards only when the expected benefits exceed the perceived costs." We wish them well in trying to implement a notion for which there is a paucity of guidance in the literature of welfare economics. We hope they will not succumb to judging the issue based on the quantity and loudness of the voices they hear. **[AIMR/FAPC92, p. 58]**

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[24] Highly-inflationary is defined as a rate of general inflation exceeding 100% for the three year period ending on the balance sheet date.

Finally, we need to consider who bears the cost of providing the information that appears in financial reports. In one very real sense there is no added compliance cost to financial statement preparers. Their salaries remain unchanged, and may even be enhanced as the scope of their responsibilities is enlarged. The costs are paid out of general corporate funds and, ultimately, are borne by the firm's investors, the users of financial statements. The cost of information is one of the prices we pay for efficient financial markets. But the benefit of rational capital allocation can be far in excess of the relatively small amounts paid to make financial markets efficient. Investors are the ones who suffer both the cost and reap the benefits of improved financial reports. We would hope that company managers, who are their agents, should not confuse their own personal interests with those of their principals. **[AIMR/FAPC92, p. 58]**

The FASB is inimical to the interests of financial statement preparers. This is a variation on the criticisms already discussed above. It can be addressed briefly. We have seen much concerted action of the part of financial statement preparers, in particular the Business Roundtable, to attempt to stifle the work of the FASB. We view these actions with much trepidation, our concern being that the size of the forces deployed by the critics of FASB might be construed as measuring the justness of their cause. **[AIMR/FAPC92, p. 58]**

The cause needs to be examined on its own merits. The discussion of specific complaints immediately above indicates that they have little or no substance. We believe that any declaration to the effect that the FASB does not serve the interests of financial statement preparers is not only wrong, it is self-serving. First, some financial analysts hold the exact opposite view; they feel that the FASB favors preparers. We also find that view self-serving. The fact is that the FASB is not to serve any specific constituent group. It is to serve equally and even-handedly everyone with an interest in financial reporting. That is why the members of the board must sever all ties with their previous employers. As long as everyone, financial analysts included, believes that their interests could be better served, the FASB must be doing a rather good job of balancing competing interests for the good of the whole. **[AIMR/FAPC92, p. 58-59]**

Does the FASB follow due process? Some commentators have taken the FASB to task for not following due process. Their view seems to be that the FASB should be following the popular view as expressed by the majority of the comments directed to it. In that view, the setting of accounting standards is (almost) entirely a political process in which lobbying is seen as a productive activity. Our view is quite to the contrary. **[AIMR/FAPC92, p. 59]**

First, we believe that the politicization of accounting should be kept to a minimum. It should not be used to serve special interests. The FASB needs information from its various constituencies that will aid it in seeing that important information is provided to financial statement users without causing undue turmoil on the part of preparers. Lobbying is an extreme form of information transmittal that has negligible legitimacy in the standard-setting process. After all, we are speaking of the measurement of economic phenomena; no matter how fine the sentiments expressed, the laws of economics defy change. **[AIMR/FAPC92, p. 59]**

Second, we are convinced that, if anything, the FASB is too concerned with due process and sunshine. In many cases, the system has acted to slow almost to a halt the pace at which new standards are issued. The stages seem excruciatingly slow on occasion. Now the FASB has gone to extended comment periods on two recent discussion memoranda.[25] We also suggest that the prohibition on a majority of the board members meeting in private or without advance public notice is unnecessary. In fact, we believe that the quality and quantity of the board's work could improve if some of it at least were sheltered from continual scrutiny. **[AIMR/FAPC92, p. 59]**

The Charge to the Oversight Committee

In its response to a request for comment on the report of the Special Advisory Group to the Board of Trustees of the Financial Accounting Foundation, the Financial Analysts Federation, one of two organizations that combined January 1, 1990 to form AIMR, disagreed with the statement that the Foundation's role is "to offer the FASB greater support in terms of advice and counsel regarding standard-setting activities."[2] We also disagreed with the notion that the trustees should consider such matters as agenda-setting, implementation matters, and relations with constituents when monitoring the standard-setting process. **[AIMR/FAF91, p. 3]**

In particular we disagreed with Recommendations (8) and (9) in the Special Advisory Group Report proposing establishment of an oversight committee with part-time paid Chairman and staff. We wrote that in our view:

> Such a proposal. . . would add an unnecessary additional layer of expense, bureaucracy, and paperwork. We view this as an attempt by the business community to gain greater control of the standard-setting process. In the event that the Foundation should pursue these recommendations, we believe that any person selected as Chairman of the Oversight Committee should have few ties to the preparer community and have a known reputation for independence and objectivity.

[AIMR/FAF91, p. 3]

In responding to the specific questions below, we have to state our hope that the Oversight Committee's interview guide and process does not set a precedent for an annual review of FASB activities for each previous five-year period. **[AIMR/FAF91, p. 4]**

Purpose of the Project

A reading of the interview guide leads us to offer the following additional comments about the purpose of the project. In the main these comments repeat material submitted previously to the Securities and Exchange Commission (SEC) during the past five years.[3] **[AIMR/FAF91, p. 4]**

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[25] Consolidation Policies and Procedures", issued September 10, 1991 with a comment deadline of July 15, 1992; and "New Basis Accounting", issued December 18, 1991 with a comment deadline of July 15, 1992.

[2] Letter of April 24, 1989 to John F. Ruffle, President of Financial Accounting Foundation.

[3] Letter of December 18, 1987 to The Honorable David S. Ruder, Chairman, Securities and Exchange Commission and Letter of October 31, 1990 to Philip R. Lochner, Jr., Commissioner, Securities and Exchange Commission.

Since the SEC holds ultimate authority over the standard-setting activities of the FASB, including the consistency of FASB actions with its mission statement, the Foundation's Oversight Committee appears to us to be performing a redundant, unnecessary, and costly function during a period in which resources are tight. **[AIMR/FAF91, p. 4]**

The repeated comment in the interview guide that the Oversight Committee "will not impair, in fact or perception, the independence of the FASB with regard to the technical content of standards" is reassuring. We would welcome an equally strong statement that both the Oversight Committee and the Financial Accounting Foundation will not impair, in fact or perception, the independence of the FASB with regard to standard-setting activities, including agenda-setting, implementation and transition matters, and relations with sponsoring organizations and the public. **[AIMR/FAF91, p. 4-5]**

Confidentiality

We note that responses to the Oversight Committee's request for comment will be held in confidence. We have no objection to dissemination of our response; in fact, we welcome it. **[AIMR/FAF91, p. 5]**

In response to the Oversight Committee's questions, we will summarize below many of the comments submitted within the past five years by our Financial Accounting Policy Committee (FAPC) about specific standards and the standard-setting process. It is the function of the FAPC to comment to the FASB (and other standard-setting bodies) about proposed accounting standards. Committee representatives testify at FASB hearings related to proposed standards and participate in FASAC and task forces. The committee also meets periodically with individual members of the FASB and/or its staff in response to FASB requests for input. The committee also schedules an annual public meeting with the full board and representatives of its staff. These discussions lead us to believe that the members of the FASB--and its staff--know and understand our point of view. That they do not necessarily heed it or adopt it is entirely another matter. **[AIMR/FAF91, p. 5-6]**

Our submission to the FASB are, of course, public documents. In addition to FASB's disclosure of written comments and testimony, we have a relatively extensive dissemination list of our own. We are questioned sufficiently often by the press and, at times, by representatives of publicly listed companies and accounting firms, to believe that our comment letters are read. **[AIMR/FAF91, p. 6]**

The members of the FASB and its staff also know that we feel very strongly that FASB efforts to placate some issuers have led to specific provisions within individual standards with which our committee finds fault. Despite this, by and large, we feel that the FASB is meeting its own objective that "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."[4] **[AIMR/FAF91, p. 6]**

[4] Statement of Financial Concepts No. 1, Objectives of Financial Reporting by Business Enterprises, Nov. 1978, at viii.

How Well is the FASB Accomplishing Its Mission?
Overall, we believe that the FASB is doing a good job. We do, however, have three 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; and
3. Pronouncements concerned with balance sheet presentation with little attention to how the results are reported in the income statement.

[Also partly included in 2(c)] **[AIMR/FAF91, p. 7]**

These concerns have been communicated to the FASB in a public meeting, by summary letter, and in individual comments on individual standards [and are the subject of the following pages, which are included in several of the categories of the database - 1(b), 2(c), 3(c), 5(a), and 5(c)].
[AIMR/FAF91, p. 7]

Factors contributing to the FASB's Success or Lack of It. When the FASB focuses on the Objectives of Financial Statements that were its inheritance from the Trueblood Study Group, and its own Statement of Financial Accounting Concepts No. 1 (Objectives of Financial Reporting by Business Enterprises), it appears most successful to us. Where it is deflected by attempts to accommodate "constituents," it appears to us to be least successful. **[AIMR/FAF91, p. 14]**

The inconsistency of provisions for the date of compliance with new standards and the alternatives permitted during transition periods appear to us to be accommodations to some issuers who argue for time to rewrite computer programs, gather data, or otherwise prepare for compliance. Such needs are perfectly understandable, but elasticity in effective date and terms of transition reporting defeats the needs of users. **[AIMR/FAF91, p. 14]**

In addition the concept of "constituents" in the context of conceptually sound standards, Precept 2, is one that troubles us. We tend to believe that the root of much of the criticism received by the FASB is in the use of the word "constituent." The word implies the relationship of the elected representative, who continually must balance the needs and benefits expected by electors with that of the general welfare. That is not, and should not be, the role of the FASB. **[AIMR/FAF91, p. 14-15]**

Overall FASB's role was spelled out in the Objectives of Financial Statements developed by the Trueblood Study Group, which concluded "that the development of objectives should not be based on the operating needs of the managers of businesses, but rather on the needs of users of financial information outside enterprises or organizations."[5] **[AIMR/FAF91, p. 15]**

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[5] Objectives of Financial Statements: **Report of the Study Group on the Objectives of Financial Statements, American Institute of Certified Public Accountants, October 1973, at 9-10.**

Objective 3 [Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process]. Two of the FASB's most cherished traditions, careful attention to the views of "constituents" and its elaborate and time-consuming due process procedures, are in direct conflict with the objective of prompt consideration of significant areas of deficiency in financial reporting. Our experience has been that through the Emerging Issues Task Force, FASAC, and the normal give and take of discussions, meetings, and correspondence with accountants, preparers, academics, users, and others, the FASB has developed the "screens" necessary to highlight significant areas of deficiency. **[AIMR/FAF91, p. 16]**

Except in one or two exceptional instances (delaying the FAS No. 96 implementation date for one and FAS No. 104 amending No. 95 and the occasional provision of technical bulletins), and despite its knowledge that standards are necessary and overdue, the FASB process allows for slow and tortuous decision-making. Standards that were overdue include FAS Nos. 105 and 106 (Postretirement Benefits Other than Pensions). Users found problems with applications of FAS No. 14 early on and have called attention to them for more than a decade. Users applauded the announcement that there would be research in the segment area, albeit occasioned by implementation of FAS No. 94, but no result is expected for years to come. In the user's order of priorities such action has been on the top of the list for much too long. **[AIMR/FAF91, p. 17]**

Precept 2 [*To weigh carefully the views of its constituents in developing concepts and standards*]. We believe wholeheartedly in the FASB's system of due process. The major problem we perceive is that the way the system is employed handicaps any effort to provide statements on a more timely basis. That is, it takes too long for a standard to find its way between the initiation date and the implementation date. The technology driven age in which we live is formulating new equations between relevance and timeliness that the FASB needs to address. Our concerns in the area the interview guide explores here were discussed earlier in this response. **[AIMR/FAF91, p. 21]**

Frustrations continue in the task force process. We continue to hope that having a member of the FASB as chairman will have beneficial results for both the board and the members of task forces. **[AIMR/FAF91, p. 21]**

The FASB can always do more to communicate that it has considered the views of all parties. We hear major complaints from some issuers that its views are not heard. We could echo those complaints in equal volume but we do not have the time, funds, or inclination to do so. It is perhaps a sign that the system works that both communities can voice the same complaint. **[AIMR/FAF91, p. 21]**

Precept 3 [*To promulgate standards only when the expected benefits exceed the perceived costs*]. When the various arguments related to the cost/benefit equation are applied to accounting standards, it seems that the only inarguable conclusion can be that a standard that helps enterprises report economic reality is the ultimate benefit that outweighs the costs to both preparers and users. Unfortunately, the way the cost benefit rule is formulated, it appears to place the burden of proof on the user of financial statements. Since it is almost always the user that is seeking change, it appears that the user must demonstrate that the benefits outweigh the costs. **[AIMR/FAF91, p. 21-22]**

We repeat here comments on the cost of accounting standards and disclosure vs. their benefits previously conveyed to SEC Commissioner Philip R. Lochner, Jr. **[AIMR/FAF91, p. 22]**

> The cost of not applying appropriate accounting and disclosure principles is most vividly and currently evident in the meltdown of shareholder and debt holder investments in savings and loan institutions. Two elements are necessary in any comparison of that cost with the cost of developing and implementing an accounting and disclosure system that would reveal the "underlying reality"[8] and economic integrity of the institutions:
>
> 1. The equity holder is an owner of a business and bears a pro rata share in every cost of doing business. Disclosure to the stock holder is not a corporate frill provided by benevolent management but an obligation of those retained to manage an enterprise to those who participate in the ownership and carry their fair share of risk and reward of the business. If there is no reward, the stock holder simply loses income on the investment. If the risk is extreme, the stock holder loses the investment.
>
>   The debt holder also has a monetary stake in the enterprise but is in a more advantaged position than the equity owner and may recoup some, if not all, of an investment even if the agreed upon return is lost.
>
> 2. The cost to investors of a financial debacle, whether industry-wide as with the S&L failures, or isolated to one company, as is the case of Caterpillar's failure to disclose its dependence on its Brazilian operations, outweighs the cost of adequate accounting and disclosure. The minimum costs of nondisclosure to the enterprises in both instances include major stock price declines as well as diminished corporate credibility.
>
> The interaction of reality-related accounting and disclosure with the analysis of securities professionals yields the ultimate benefit--a fair and efficient market. Bevis Longstreth, a former SEC Commissioner, described this result in a relatively recent book:
>
>> Today, the efficiency of our capital markets is much more a product of rapid dissemination of information, its analysis by professionals, and the investment decisions of institutional investors relying on that analysis than of the trading by insiders and those with special access to insiders. Over the years the security analyst has replaced the inside source as the key to sound investment choice within an actively managed portfolio.[9]

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[8] Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Issues Involving Financial Institutions and Accounting Principles, before the Committee on Banking, Housing and Urban Affairs, United States Senate, September 10, 1990.

[9] Longstreth, Bevis, Modern Investment Management and the Prudent Man Rule, New York, Oxford Press, 1986, at 72.

John C. Coffee, Jr. of Columbia University Law School offered four major arguments in favor of a mandatory disclosure system in a Virginia Law Review article.[10]

1. Because information has many characteristics of a public good, securities research tends to be underprovided. . . . A mandatory disclosure system can thus be seen as a desirable cost reduction strategy through which society, in effect, subsidizes search costs to secure both a greater quantity of information and a better testing of its accuracy. . . . It [improves] the allocative efficiency of the capital market--and this improvement in turn implies a more productive economy.

2. Greater inefficiency would exist without a mandatory disclosure system because excess social costs would be incurred by investors pursuing trading gains.

3. The theory of self-induced disclosure. . . . has only a limited validity. A particular flaw in this theory is that it overlooks the significance of corporate control transactions and assumes much too facilely that manager and shareholder interests can be perfectly aligned. . . . Instances will arise in which management can profit by giving a false signal to the market.

4. Even in an efficient capital market, there remains information that the rational investor needs to optimize his securities portfolio. Such information seems best provided through a mandatory disclosure system.

From time to time analysts have been asked for a cost/benefit analysis of one disclosure requirement or another. AIMR's accounting committee made a fairly wide search several years ago for a model that might be used for such analysis. We discussed the matter with several academics as well as statistics experts. Those discussions convinced us that there is neither a commonly accepted model nor a convincingly workable one to compare costs that may be quantifiable in terms of such expenses as personnel, computer time, and printing and distribution with the benefits of rapid dissemination of information in the marketplace and such savings as may be achieved in the research time of professional and individual investors. We know that investors ask many questions of management. We would expect them to ask many more questions should timely, relevant information not be available.

[AIMR/FAF91, p. 22-24]

Several of the standards issued during the past five years have provided less in terms of benefits to users than they cost in terms of destruction of data and loss of comparability and consistency. We would not, however, except in the case of FAS No. 96, agree that the standards failed to provide benefits that exceed the costs of providing information necessary to reflect the economic reality of an enterprise. **[AIMR/FAF91, p. 24]**

Field tests. We stated our belief earlier in this response that analyst participation in a cash flows field test might have prevented the disenchantment that has replaced initial support for the indirect method adopted in FAS No. 95. **[AIMR/FAF91, p. 24]**

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[10] Coffee, John C., Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System," Virginia Law Review (Oct. 1984, Vol. 70:717) at 721-723.

In one of its annual meetings with the FASB, AIMR's Financial Accounting Policy Committee suggested that users be included in field tests. Fear that inside information would be made available made the FASB cautious about pursuing analyst interest here. The committee also made the same suggestion to representatives of the Committee on Corporate Reporting of the Financial Executives Institute. It was agreed, we believe, that, at a minimum, user review of proposed field test questions would be helpful. **[AIMR/FAF91, p. 25]**

Analysts continue to believe that ways can be found to erect a Chinese Wall to prevent use of any nonpublic information that might be obtained through a field test relationship. Many analysts are academics who do not manage money. Others are specialists whose interests are confined to one industry or industry sector but whose skills could be transferred to another industry involving companies they do not follow. **[AIMR/FAF91, p. 25]**

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 2(c)] **[AIMR/FAF91, p. 25]**

Precept 5 [*To review the effects of past decisions and interpret, amend, or replace standards in a timely fashion when such action is needed*]. As we stated earlier in this response, we believe that the FASB's informal and formal interactions with the bodies concerned with accounting standards provides adequate information about problems associated with individual standards, their timeliness, and the necessity for amended or new standards. **[AIMR/FAF91, p. 25-26]**

General Questions

FASAC--We believe that FASB's relationship with FASAC is satisfactory.

Technical Staff--By and large we find FASB's technical staff satisfactory but sorely lacking exposure to, and experience with, financial statements from the user point of view. Since the pool of analytical talent is relatively small, and since analysts are not accountants and so are not likely to be of as much assistance as a staff member who can deal with the technical aspects of accounting, we wonder whether the sensitivity of the FASB's technical staff to user needs and methodologies would be enhanced by experience as interns in the research departments of broker-dealers, investment advisory firms, banks, insurance companies, or pension funds. **[AIMR/FAF91, p. 26]**

Functioning of trustee or board member--More time spent with representatives of the users of financial statements and more representation of users on the trustees and the board seem to us essential. **[AIMR/FAF91, p. 26]**

The FASB's Mission, Objectives and Precepts

With the exception of Precept 2, discussed above, we believe that the Objectives and Precepts are appropriate. **[AIMR/FAF91, p. 27]**

There is a gap in the Objectives and Precepts relating to the Concepts Statement of the Objectives of Financial Statements. If the desired result is as stated--that is, to provide information useful to present and potential investors and creditors, and other users in making rational decisions, it appears to us that a new Objective 1 should be added to state that goal. By and large the user has been the invisible guest at the accounting standards-setting table. **[AIMR/FAF91, p. 27]**

<u>The FAF's Oversight Responsibilities and Process</u>
We firmly believe that the Foundation's oversight activities should be restricted to those stated in the initial incorporation documents, i.e. financing and budget without power to omit or undertake any particular projects or activities or otherwise affect FASB functions and powers relating to standards of financial accounting and reporting; review of bylaws and structure; and election of members of the FASB. **[AIMR/FAF91, p. 27]**

Oversight for such a foundation should be a relatively simple process. **[AIMR/FAF91, p. 27]**

Since we believe that the function of the Oversight Committee is redundant, we do not think it necessary that the committee publish any report but that any matters necessary for comment come through the annual report of the Trustees. **[AIMR/FAF91, p. 28]**

Other issues that we believe the Trustees (or the SEC) should consider:

a. The perception that the FASB is under undue political pressure from some issuers to favor managements' accounting goals.

b. The perception that most if not all accounting firms have lost their ability to maintain an independent attitude.

c. That the contribution of funds, or the lack thereof, gives special status or voice to the contributor.

d. The continuing dearth of bona fide user representatives on the FASB.
[AIMR/FAF91, p. 28]

[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 2(d)] **[GOLDMAN, p. 2]**

[Context] Letter sent to the FASB Chairman by an analyst.

> [Agenda setting] is one of the single most important activities of the Board; it determines how effectively Board time will be spent over the next several years. Any [investment] professional should be able to appreciate the significance of that effort. As [has been pointed] out, this activity is nearly invisible to the user community at large. **[R.G. ASSOCIATES, p. 1]**
>
> How to make it visible? I think that the Board may be on the right track with its "prospectus" approach on a mortgage servicing rights project, but I don't know how effective it has been so far. To make the agenda setting process more visible in the analyst community, I would again suggest getting some of the technical staff members on the analyst society luncheon circuit. They could easily discuss current and potential agenda projects; if done properly, they could provide relevant first-hand intelligence to the Board for defying the agenda while bringing some appreciation of the process to the constituency. **[R.G. ASSOCIATES, p. 1]**
>
> I believe that analysts would immediately understand the problems in agenda-setting; however, I think we have short memories. I'm not certain that any long-lasting communication benefit would be gained from this, but I still believe that the input aspect of this exercise would make it justifiable. **[R.G. ASSOCIATES, p. 1]**

12.c.17

CHAPTER 1: DEFINING THE PROPER ROLE FOR SETTING FINANCIAL ACCOUNTING AND REPORTING STANDARDS

There is near unanimity among all groups on the basic necessity to have an authoritative body for setting financial accounting and reporting standards: 93% feel there is a great deal of need for such standards setting, up from 86% who felt that way back in 1980.

Table 1.1

PERCEIVED NEED FOR FINANCIAL ACCOUNTING AND REPORTING STANDARDS

	1985	1980
	%	%
A great deal of need	93	86
Some but not a lot	6	13
Hardly any	*	1
Not sure	–	*

*Less than .5%.

Following is a breakdown by 1985 respondents on the perceived need for financial accounting and reporting standards.

Table 1.2

PERCEIVED NEED FOR STANDARDS: BREAKDOWN BY RESPONDENTS

Q.1—How much do you feel there is a need for financial accounting and reporting standards?

	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
A great deal	93	91	91	88	96	95	100	91	100	93	80	84	100	94
Some but not a lot	6	9	8	12	4	5	–	7	–	–	20	16	–	6
Hardly any	*	–	1	–	–	–	–	2	–	7	–	–	–	–
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

By the same token, there is almost just as strong a preference that the function of establishing standards of financial accounting and reporting be carried out in the private rather than the public sector in spite of the fact that, under the law, the SEC has the statutory power to set standards.

Table 1.3

IMPORTANCE OF PRIVATE RATHER THAN PUBLIC SECTOR GENERATING STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Q.1B—Under the Securities Exchange Act of 1934, the SEC has the statutory authority to establish standards of accounting and reporting. But for more than four decades, it has been the stated policy of the SEC to look to the private sector for performance of this function, despite criticism of this practice in Congress at various times. How important do you feel it is for the private sector to continue to perform this accounting standards function—highly important, somewhat important, not very important, or not important at all?

	1985	1980
	%	%
Highly important	87	85
Somewhat important	11	9
Not very important	1	2
Not important at all	1	2
Not sure	*	2

*Less than .5%.

Observation: *It is patently apparent that there is a deep-felt need to have standards established for financial accounting and reporting. At the same time, it is equally apparent that overwhelming sentiment wants this function to be performed in the private and not in the public sector.*

Following is a breakdown by 1985 respondents on the importance of the public sector generating standards of financial accounting and reporting.

Table 1.4

STANDARDS SETTING IN THE PRIVATE SECTOR: BREAKDOWN BY RESPONDENTS

		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	87	90	92	91	86	71	85	93	93	93	93	94	82	65
Somewhat important	11	9	6	9	11	22	13	4	7	–	7	6	18	12
Not very important	1	–	–	–	4	5	2	–	–	–	–	–	–	–
Not important at all	1	1	–	–	–	2	–	2	–	7	–	–	–	18
Not sure	*	–	1	–	–	–	–	–	–	–	–	–	–	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

18.e.19 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		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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]

[8.e.3] In order to test this issue further, the sample was asked about the amount of emphasis that the FASB requires to be placed on the information needs of external users of financial reports.

Table 1.8

EMPHASIS OF FASB ON NEEDS OF EXTERNAL USERS OF FINANCIAL REPORTS

Q.4B—Do you feel the FASB places too much, too little, or the right amount of emphasis on the information needs of external users of financial reports?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Too much emphasis	21	27	28	15	32	10	16	18	–	20	33	35	8	–
Too little	19	14	11	24	7	32	33	9	7	13	7	23	13	41
Right amount	54	56	54	55	57	46	41	71	93	60	60	39	71	53
Not sure	6	3	6	6	4	12	10	2	–	7	–	3	8	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

On an overall basis, it is evident that just about as many feel that the FASB places too much as too little emphasis on the information needs of external users of financial reports. However, in every case, among every group, a majority or plurality is also convinced that the FASB gives the right amount of emphasis to the needs of external users. In fact, when those who say there is "too little" emphasis are added to those who say there is "the right amount" of emphasis placed by the FASB, an overwhelming 73-21% majority rejects the charge that too much emphasis is given to the needs of external users.

Observation: *There is little evidence here that the financial community is upset or disturbed at all over the claims that the FASB has given a higher priority to the needs of external users of financial reports. To the contrary, meeting those needs is widely believed to be a high priority for financial reporting.*

[HARRIS]

Perceived Key Users of Financial Information

18.2.22 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						
	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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]

18.2.23

Table 1.10 (continued)

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

		Large Public Companies						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
				C. E. O.										
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]

18.C.24

Table 1.10 (continued)

ESTIMATED IMPORTANCE OF USERS OF FINANCIAL REPORTS: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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]

18.2-25

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]

18.2.26

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]

18.e.27 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	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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]

Table 1.13

WHO SHOULD BE THE MOST IMPORTANT USERS OF FINANCIAL REPORTS: BREAKDOWN BY RESPONDENTS

18.2.28 Q.3C—Which of the following do you feel should be the most important users of financial reports?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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]

18.e.29 "Broad" or "General" Standards vs. "Detailed" or "Specific" Standards

Yet another dichotomy that has been the subject of much discussion in the financial world has been that of broader or more general standards that deal with accounting issues that are common throughout business, compared with those issues that affect only a small number of companies or industries.

The survey tested this issue in some depth:

Table 1.14

BROAD VS. NARROW ISSUES

Q.5A—Do you believe that the FASB should concern itself only with broad accounting issues that are pervasive throughout much of the business world, or should it also deal with issues that may be of great importance to only a relatively small number of companies?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Only broad accounting issues	63	65	61	61	64	66	57	58	53	53	67	90	55	53
Also issues of importance to small numbers of companies	32	26	32	39	32	32	36	38	40	40	33	6	42	47
Both equally	3	6	4	–	–	2	3	–	–	–	–	–	3	–
Not sure	2	3	4	–	4	–	3	4	7	7	–	3	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

The 63-32% majority overall favoring concentration on only broad accounting issues appears at least at first glance to be decisive. A majority of every group shares this basic view. The two groups with the closest division are academics and the financial media, who, significantly, do not make day-to-day business, investment, or professional decisions based on FASB standards but instead are major observers of the process.

[HARRIS]

18.2.30 However, the survey then went on to ask if the FASB does not deal with some issues that are of importance to just a relatively few companies, then who should deal with them? These results are equally clear-cut:

Table 1.15

WHO SHOULD DEAL WITH INDUSTRY-SPECIFIC ISSUES

Q 5B—If the FASB does not deal with some issues that are of importance just to relatively few companies, who then should deal with them?

	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
AICPA	57	56	52	52	50	32	64	84	80	73	100	58	68	47
SEC	11	4	6	24	11	29	10	2	–	7	–	6	16	29
Industry associations	19	22	30	15	29	32	10	9	13	13	–	19	5	12
FASB	2	4	1	–	–	–	3	2	–	7	–	–	–	–
More than one organization	1	1	1	–	–	–	2	2	7	–	–	–	–	–
No organization	8	10	8	9	7	5	7	–	–	–	–	16	5	12
Not sure	2	–	1	–	4	2	5	–	–	–	–	–	5	–
No answer	*	3	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

The alternative to the FASB dealing with these issues of importance to a limited number of companies clearly is the American Institute of Certified Public Accountants (AICPA), singled out by 57% for this task. Executives from the large accounting firms feel most strongly about this alternative, followed by academics and bank lending officers.

[HARRIS]

18.e.31 A real question raised by these results, however, is whether those answering the survey probes mean that the FASB should avoid generally those accounting issues that affect only a few companies or whether it also means that the FASB should deal mainly in writing broad, general standards or should promulgate standards that are highly detailed with little room for interpretation?

Each person in the sample, therefore, was asked:

Table 1.16

BROAD VS. DETAILED STANDARDS

Q.5C—Do you believe the FASB should write its standards in broad, general terms that would leave room for judgment by preparers and auditors in applying them or do you prefer detailed standards that leave little room for interpretation or should the degrees of specificity depend on the kind of issue involved?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Write rules in broad terms with room for judgment	34	47	44	24	32	24	25	36	33	33	40	23	26	29
Have detailed standards with little interpretation necessary	13	6	5	24	14	17	25	11	7	20	7	6	11	18
Depends on issue	54	46	51	52	54	59	51	53	60	47	53	71	63	53
Not sure	–	–	–	–	–	–	–	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

While more than twice as many people favor writing rules in broad terms with ample room for judgment than want detailed standards with as little interpretation as possible, it is also evident that a majority favors neither alternative. Instead, 54%, easily the largest group across the board, said "it depends on the issue."

Observation: *It is apparent that there is a mandate for the FASB to try to avoid most issues that have applicability to only a few companies or industries. Most would like the FASB to deal with broader accounting issues. They would opt for using the AICPA for those highly specialized cases. But this mandate clearly does not extend to the substance of FASB standards: it should not be bound by having to write standards in broad terms or in highly detailed terms. In short, a clear majority wants the FASB to have a wide latitude on the substance of its standards.*

[HARRIS]

18.2.32 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?

	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	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]

18.6.33 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

	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	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]

18.2.34

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?

	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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]

Where the Art of Accounting Is Headed

As in 1980, the 1985 study probed some much discussed possible trends that might be shaping
18.2.35 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]

Following is a breakdown by respondents on possible developments in the future state of the art of accounting.

18.8.36

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	-	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	-	-	-	3	3	-
No answer	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Data such as earnings forecasts will be required in financial reports														
Highly likely	9	1	10	3	4	-	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	-	-	-	-	-	-
No answer	-	-	-	-	-	-	-	-	-	-	-	-	-	-

[HARRIS]

18.E.37

Table 2.7 (continued)

POSSIBLE FUTURE DEVELOPMENTS: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Data such as reporting of responses to social responsibilities will be required in financial reports														
Highly likely	4	–	5	3	*	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)?

	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 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]

18.2.38

Table 2.8 (continued)

WHETHER FUTURE DEVELOPMENTS WOULD BE POSITIVE OR NEGATIVE CHANGES: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
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	5	3	–	4	7	11	4	–	7	7	6	11	12
No answer	*	*	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	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%

[HARRIS]

CHAPTER 3: HOW THE FASB IS CONSTITUTED AND THE GROUND RULES UNDER WHICH IT OPERATES

18.2.39 How the FASB, FASAC, and FAF Are Selected

The process by which the components of the standards-setting structure, the Financial Accounting Standards Board, the Financial Accounting Standards Advisory Council, and the trustees of the Financial Accounting Foundation, are selected were all described to the people interviewed, and in each case a judgment was solicited about the method of selection.

Table 3.1

HOW THE SYSTEM OF SELECTION IS RATED

Q.9A—The Financial Accounting Standards Board is made up of seven full-time members, all experienced in accounting and finance and drawn from public accounting, the corporate, financial, academic, and governmental sectors. The Board members are selected by the trustees of the Financial Accounting Foundation. How would you rate the makeup and process of selecting the FASB—excellent, pretty good, only fair, or poor?

Q.9B—The Financial Accounting Standards Advisory Council is also appointed by the trustees of the Financial Accounting Foundation and is designed to be a cross-section of the FASB's various constituencies. How would you rate the makeup and process of selecting the Financial Accounting Standards Advisory Council—excellent, pretty good, only fair, or poor?

Q.9C—The trustees of the Financial Accounting Foundation are selected in a different way. Under the by-laws, each of several groups has a set number of people represented on the FAF. They nominate people from their ranks and then the heads of all groups meet and vote on the entire slate. The groups include the National Association of Accountants, the Securities Industry Association, the American Accounting Association, the American Institute of CPAs, the Financial Analysts Federation, and the Financial Executives Institute. How would you rate the makeup and process of selecting the Financial Accounting Foundation—excellent, pretty good, only fair, or poor?

	Positive	Negative	Not Sure
	%	%	%
9A. Financial Accounting Standards Board	78	13	9
9B Financial Accounting Standards Advisory Council	70	13	17
9C Financial Accounting Foundation	75	14	10

[HARRIS]

18.6.40 The breakdown of responses to Question 9 by category is as follows:

Table 3.2

HOW THE SELECTION SYSTEM IS RATED: BREAKDOWN BY RESPONDENTS

Q.9—How would you rate the makeup and process of selecting the (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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Financial Accounting Standards Board														
Excellent	26	29	33	18	18	24	13	33	47	27	27	10	45	29
Pretty good	51	55	51	52	61	51	46	47	47	33	60	71	39	47
Only fair	12	10	10	12	14	15	11	18	7	33	13	6	11	12
Poor	2	3	1	6	–	–	–	–	–	–	–	3	3	–
Not sure	9	3	5	12	7	10	30	2	–	7	–	10	3	12
———Positive	78	85	84	70	79	76	59	80	93	60	87	81	84	76
———Negative	13	13	11	18	14	15	11	18	7	33	13	10	13	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Financial Accounting Standards Advisory Council														
Excellent	19	21	29	12	11	22	7	22	27	20	20	6	29	12
Pretty good	51	49	42	55	61	49	52	62	60	60	67	65	42	47
Only fair	12	9	15	6	11	15	13	4	–	13	–	6	18	18
Poor	2	3	–	6	–	–	–	2	–	–	7	3	3	–
Not sure	17	19	14	21	18	15	28	9	13	7	7	19	8	24
———Positive	70	69	71	67	71	71	59	84	87	80	87	71	71	59
———Negative	13	12	15	12	11	15	13	7	–	13	7	10	21	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Financial Accounting Foundation														
Excellent	32	35	39	33	36	39	16	38	33	53	27	13	39	18
Pretty good	43	47	44	36	39	41	41	53	67	33	60	48	32	41
Only fair	12	8	11	9	4	12	15	4	–	7	7	23	13	29
Poor	3	3	1	3	4	–	3	2	–	–	7	10	3	–
Not sure	10	8	4	18	18	7	25	2	–	7	–	6	11	12
———Positive	75	82	84	70	75	80	57	91	100	87	87	61	71	59
———Negative	14	10	13	12	7	12	18	7	–	7	13	32	16	29
No answer	*	–	–	–	–	–	–	–	–	–	–	–	3	–

*Less than .5%

Note: Answers of "excellent" and "pretty good" are combined into "positive" while answers of "only fair" and "poor" are combined into "negative."

[HARRIS]

By wide margins of 3 to 1 or better, the selection process for constructing the three main bodies that lie at the heart of the standards-setting system of financial reporting in the United States meets with approval.

Observation: *It is evident from these results, which cut across every part of the spectrum of this informed financial community, that the method of selection is seen as fair and equitable and representative, with all key groups given a reasonable voice.*

(8.2.4)

How the FASB Draws Up Its Technical Agenda

The people surveyed were asked about the way the FASB decides on what its technical agenda will be. They were then asked:

Table 3.3

APPROPRIATENESS OF FASB AGENDAS

Q.10A—How proper and appropriate do you feel the technical agendas of the FASB have been?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Very proper and appropriate	25	22	25	15	25	32	25	31	47	7	40	19	32	29
Somewhat proper and appropriate	57	64	59	67	57	49	46	56	53	73	40	65	58	41
Not very proper and appropriate	9	13	10	6	4	2	7	9	–	13	13	16	11	6
Not proper and appropriate at all	1	–	–	3	–	5	–	2	–	–	7	–	–	–
Not sure	8	1	5	9	14	12	23	2	–	7	–	–	–	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

By and large, an 82-10% majority overall feels that the technical agenda has been proper and appropriate. Of course, it should be noted that a majority of 57% qualifies its answer by opting for "somewhat proper and appropriate," undoubtedly reflecting upon the pragmatic and relative nature of any technical agenda. By the same token, no more than 10% were critical of the resulting technical agendas.

[HARRIS]

Then the same people were asked about the criteria that are used by the FASB in determining its technical agenda. Each person surveyed was given a copy of these criteria and then asked if they were adequate or not.

18.e.43

Table 3.4

ADEQUACY OF CRITERIA USED TO DETERMINE TECHNICAL AGENDA

Q.10B—Now let me hand you this card On this card are the criteria the FASB follows in deciding on its technical agenda. Do you feel these criteria are adequate or not in helping the FASB to determine its agenda?

Criteria Used by FASB in Determining Its Technical Agenda

1 Pervasiveness of the problem: the extent to which an issue is troublesome to users, preparers, auditors, or others the extent to which there is diversity of practice; and the likely duration of the problem (i.e., is it transitory or will it persist?)

2. Alternative solutions: the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability, and comparability are likely to be developed.

3 Technical feasibility: the extent to which a technically sound solution can be developed, or whether the project under consideration should await completion of other projects.

4 Practical consequences: the extent to which an improved accounting solution is likely to be acceptable generally and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress.

	Total Sample
	%
Adequate	92
Not adequate	5
Not sure	2

Observation: *Clearly, there is nearly unanimous agreement that the criteria used for determining the technical agenda of the Financial Accounting Standards Board are wholly adequate for the task at hand.*

[HARRIS]

18.e.43

Table 3.8

PERCEPTION OF APPROPRIATENESS OF RULES OF PROCEDURE: BREAKDOWN BY RESPONDENTS

Q 11B—Do you feel the following is a proper and appropriate procedure or role for the FASB . . (READ EACH ITEM)?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
In selecting topics for its technical agenda, establishing priorities, and considering general policy matters, the Board receives advice from the Financial Accounting Standards Advisory Council whose 37 members represent all the various groups having an interest in financial reporting														
Proper and appropriate	89	85	99	88	93	83	85	91	100	87	87	84	89	94
Not proper and appropriate	3	5	1	–	–	2	3	2	–	–	7	10	5	–
Not sure	6	8	–	9	7	12	10	7	–	13	7	–	5	6
No answer	2	3	–	3	–	2	2	–	–	–	–	6	–	–
For each of its major projects, the FASB appoints a task force of people who have expertise on the subject to advise on the scope of the project, what research should be conducted, and how the issues should be presented for public discussion														
Proper and appropriate	95	96	100	85	93	93	90	98	100	93	100	100	95	100
Not proper and appropriate	*	1	–	–	–	–	–	–	–	–	–	–	3	–
Not sure	4	3	–	9	7	7	8	2	–	7	–	–	3	–
No answer	1	–	–	6	–	–	2	–	–	–	–	–	–	–
As a basis for a public hearing, a discussion memorandum setting forth the issues and the alternative solutions to them is given wide distribution at least 60 days before the hearing														
Proper and appropriate	94	97	100	88	82	83	89	98	100	93	100	94	97	100
Not proper and appropriate	2	1	–	6	7	5	2	–	–	–	–	3	–	–
Not sure	4	1	–	6	7	10	8	2	–	7	–	3	3	–
No answer	1	–	–	–	4	2	2	–	–	–	–	–	–	–
Any individual or organization may appear at the hearing or may submit written comments on the discussion memorandum														
Proper and appropriate	94	97	97	91	96	85	85	93	100	87	93	97	97	94
Not proper and appropriate	2	1	3	–	–	–	3	4	–	7	7	–	3	6
Not sure	4	1	–	9	4	10	10	2	–	7	–	3	–	–
No answer	1	–	–	–	–	5	2	–	–	–	–	–	–	–

[HARRIS]

Table 3.8 (continued)

18.2.4 **PERCEPTION OF APPROPRIATENESS OF RULES OF PROCEDURE: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
The Board conducts its deliberations in meetings that are open to the public														
Proper and appropriate	88	94	90	85	89	80	79	96	100	87	100	97	79	100
Not proper and appropriate	6	3	9	3	4	2	11	–	–	–	–	3	16	–
Not sure	5	4	1	9	7	15	8	4	–	13	–	–	5	–
No answer	1	–	–	3	–	2	2	–	–	–	–	–	–	–
Before it adopts a standard, the Board distributes an exposure draft of the proposed standard for public comment, generally for a 60-day period														
Proper and appropriate	93	99	100	85	93	80	89	96	100	87	100	90	95	100
Not proper and appropriate	3	–	–	6	4	7	2	2	–	7	–	6	5	–
Not sure	4	1	–	9	4	12	8	2	–	7	–	3	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Each exposure draft and each Statement of Financial Accounting Standards explain the basis for the Board's conclusions														
Proper and appropriate	96	97	100	91	96	90	89	98	100	93	100	97	100	100
Not proper and appropriate	1	1	–	3	–	–	2	–	–	–	–	3	–	–
Not sure	3	1	–	6	4	10	8	2	–	7	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Each final Statement identifies the Board members who voted for and against adoption along with dissenting opinions														
Proper and appropriate	84	91	82	76	79	73	74	93	100	93	87	90	87	100
Not proper and appropriate	8	6	13	9	4	12	11	4	–	–	13	6	8	–
Not sure	7	3	4	12	18	10	13	2	–	7	–	3	5	–
No answer	1	–	1	3	–	5	2	–	–	–	–	–	–	–
Any individual or organization may request that the FASB review or reexamine any pronouncement														
Proper and appropriate	86	86	90	85	93	71	79	93	100	87	93	94	84	100
Not proper and appropriate	7	6	9	3	–	15	8	2	–	7	–	3	11	–
Not sure	6	8	–	9	7	12	11	4	–	7	7	3	5	–
No answer	1	–	1	3	–	2	2	–	–	–	–	–	–	–

*Less than .5%

[HARRIS]

Finally, when asked to assess these nine steps in the due process procedure, an incredibly high 87-8% majority of all groups rates the way the FASB handles the process as positive, sharply up from a comparable 59-6% five years ago, when a high 35% found themselves unable to make a judgment about the way the FASB was operating under its rules of procedure.

Table 3.9

THOROUGHNESS IN OBTAINING INFORMATION AND ANALYZING ISSUES

18.2.45

Q 11C—On the matter of thoroughness in obtaining information and in analyzing issues, how would you rate the way the FASB handles this part of its due process?

	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**
	%	**%**	**%**	**%**	**%**	**%**	**%**	**%**	**%**	**%**	**%**	**%**	**%**	**%**
Excellent	39	36	37	15	46	44	33	47	67	27	47	32	68	47
Pretty good	47	55	54	67	43	44	46	36	27	33	47	48	26	41
Not so good	7	8	6	9	4	5	3	11	–	27	7	13	5	6
Poor	1	1	3	–	–	–	2	2	7	–	–	–	–	–
Not sure	5	–	–	9	7	7	16	4	–	13	–	6	–	6
———Positive	87	91	91	82	89	88	79	82	93	60	93	81	95	88
———Negative	8	9	9	9	4	5	5	13	7	27	7	13	5	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *It is also evident that, in this case, greater familiarity has engendered a much deeper seated respect for, and adherence to, the way the rules are working out.*

[HARRIS]

186.46 **The Emerging Issues Task Force**

These top financial constituents and observers were asked about the FASB's Emerging Issues Task Force, which was organized about a year ago to help assess new specific accounting issues that arise from such things as new kinds of transactions, changes in the law, and other such developments. It was also explained that sometimes the Task Force indicates that no change is required because the existing accounting literature is clear but at other times that this is not the case and that action by FASB is needed.

By over a 5 to 1 margin, a sizable majority believes that the Emerging Issues Task Force is needed.

Table 3.10

NEED FOR EMERGING ISSUES TASK FORCE

Q.11D—About a year ago, the FASB organized a special Emerging Issues Task Force to help assess new specific accounting issues. Do you feel that this new Task Force is needed?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Needed	77	73	78	76	79	71	77	80	87	67	87	77	76	88
Not needed	14	17	18	15	14	12	11	16	13	20	13	13	11	6
Not sure	9	9	4	9	7	17	11	4	–	13	–	10	13	6
No answer	*	1	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%

[HARRIS]

18.6.47

The Mission, Objectives, and Precepts of the FASB

The stated mission of the FASB was handed to each individual who was surveyed and each was asked if he or she agreed or disagreed with it. By an overwhelming 95-4%, nearly everyone is in agreement with this mission, "The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."

Table 3.11

MISSION OF THE FASB

Q 12A—In general, do you agree or disagree that the stated mission of the FASB properly defines what the FASB should be?

	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**
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Agree	95	95	92	97	93	98	97	100	100	100	100	97	92	94
Disagree	4	5	8	3	4	2	2	–	–	–	–	3	8	6
Not sure	*	–	–	–	4	–	2	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

However, when asked to assess how well the FASB performs in carrying out each objective or precept that the organization is guided by, the results vary widely.

Among the FASB's objectives, two are widely believed to be well carried out:

—By 79-19%, a solid majority believes it does well in "improving the usefulness of financial reporting by focusing on the primary characteristics or relevance and reliability and on the qualities of comparability and consistency."

—By 61-37%, another sizable majority likes the way the FASB "keeps standards current to reflect changes in methods of doing business and changes in the economic environment."

However, the group divides down the middle over how well the FASB does in carrying out two other objectives:

—By 50-47% overall, they give a negative rating to how the FASB "considers promptly any significant areas of deficiency in financial reporting that might be improved through the standards-setting process." Most critical of the perceived lack of promptness on the part of the FASB are CEOs of small public companies, technical and audit partners of the large accounting firms, heads of small accounting firms, and academics.

—By 52-45%, a majority is also critical of the way the FASB "improves the common understanding of the nature and purposes of information contained in financial reports." Here the critics are drawn most from the ranks of CEOs and CFOs of large public corporations, technical partners of large accounting firms, heads of small accounting firms, academics, and the financial media.

[HARRIS]

18.6.48 In the case of the five stated precepts of the FASB, three emerge as being particularly well carried out:

—By 81-15%, a big majority likes the way the FASB is "objective in its decision making and the way it ensures the neutrality of information resulting from its standards."

—By 73-23%, another substantial majority praises FASB for its performance in "weighing carefully the views of its constituents in developing concepts and standards, even though in the end the Board must rely most on the research, public input, and careful deliberation about the usefulness of resulting information."

—By 64-33%, another big majority believes the FASB does a positive job on "bringing about needed changes in ways that minimize disruption to the continuity of reporting practices."

But on two other precepts, the group splits down the middle in their assessment of how well the FASB performs in carrying them out:

—By 50-45%, a plurality is critical of the Board's performance in "promulgating standards only when expected benefits exceed the perceived costs." Most critical are CEOs and CFOs of large public companies, CEOs of small public companies, and heads of small accounting firms.

—By 50-40%, a plurality does like the way the FASB "reviews the effects of past decisions," although demurrers are entered by technical partners of large accounting firms, CEOs of small public companies, and heads of small accounting firms.

Table 3.12

HOW WELL THE FASB IS PERCEIVED TO CARRY OUT THE OBJECTIVES AND PRECEPTS THAT GUIDE IT

	Positive %	Negative %	Not Sure %
Objectives			
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	79	19	2
2. Keep standards current to reflect changes in methods of doing business and changes in the economic environment	61	37	3
3. Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standards-setting process	47	50	4
4. Improve the common understanding of the nature and purposes of information contained in financial reports	45	52	3
Precepts			
1. To be objective in its decision making and to ensure, insofar as possible, the neutrality of information resulting from its standards (to be neutral, information must report economic activity as faithfully as possible without coloring what it communicates)	81	15	4
2. To weigh carefully the views of its constituents in developing concepts and standards, although the ultimate determinant must be the Board's judgment based on research, public input, and careful deliberation about the usefulness of resulting information	73	23	4
3. To promulgate standards only when the expected benefits exceed the perceived costs	45	50	5
4. To bring about needed changes in ways that minimize disruption to the continuity of reporting practices	64	33	3
5. To review the effects of past decisions	50	40	10

[HARRIS]

18.6.49

Observation: *Although for the most part most of the people interviewed believe the FASB is successfully carrying out the objectives and precepts that guide it, nonetheless, many believe a better job can be done in acting more promptly to correct deficiencies in financial reporting, of enhancing the common understanding of what is required in financial reports, of justifying its standards in terms of benefits exceeding costs, and in reviewing the effects of its past decisions. All of these come under the heading of follow through in contrast to the broader objectives and precepts on which the FASB is widely viewed as doing a highly satisfactory job.*

Following is a breakdown by respondents on how well the FASB is perceived to carry out the precepts and objectives that guide it.

Table 3.13

PERCEPTION OF HOW WELL FASB CARRIES OUT ITS OBJECTIVES: BREAKDOWN BY RESPONDENTS

Q 12C-1—How would you rate how well the FASB performs in carrying out the objective to . . (READ EACH ITEM)?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency														
Excellent	21	14	22	9	36	22	31	18	27	27	–	3	24	41
Pretty good	58	64	57	70	50	56	56	53	67	33	60	71	50	47
Only fair	16	17	18	18	11	15	5	22	7	27	33	23	21	–
Poor	3	5	4	–	–	–	–	4	–	7	7	3	5	12
Not sure	2	–	–	3	4	7	8	2	–	7	–	–	–	–
————Positive	79	78	78	79	86	78	87	71	93	60	60	74	74	88
————Negative	19	22	22	18	11	15	5	27	7	33	40	26	26	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Keep standards current to reflect changes in methods of doing business and changes in the economic environment														
Excellent	12	6	5	3	36	7	25	13	27	7	7	–	18	6
Pretty good	49	53	52	45	46	54	48	44	47	40	47	61	37	47
Only fair	31	36	29	42	11	27	20	36	27	33	47	35	39	35
Poor	6	4	14	6	4	5	–	4	–	13	–	3	5	12
Not sure	3	1	–	3	4	7	8	2	–	7	–	–	–	–
————Positive	61	59	57	48	82	61	72	58	73	47	53	61	55	53
————Negative	37	40	43	48	14	32	20	40	27	47	47	39	45	47
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.6.50

Table 3.13 (continued)

PERCEPTION OF HOW WELL FASB CARRIES OUT ITS OBJECTIVES: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standards-setting process														
Excellent	8	6	6	–	11	7	11	16	20	13	13	–	8	6
Pretty good	39	41	43	24	57	39	43	27	33	20	27	32	37	53
Only fair	39	41	41	61	25	34	28	44	40	53	40	48	37	29
Poor	11	10	10	9	4	12	7	11	7	7	20	19	18	6
Not sure	4	1	–	6	4	7	11	2	–	7	–	–	–	6
–––––Positive	47	47	49	24	68	46	54	42	53	33	40	32	45	59
–––––Negative	50	51	51	70	29	46	34	56	47	60	60	68	55	35
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Improve the common understanding of the nature and purposes of information contained in financial reports														
Excellent	12	6	11	15	11	17	20	7	7	13	–	10	13	18
Pretty good	33	33	33	36	43	32	31	42	47	20	60	23	32	24
Only fair	35	45	39	24	29	34	31	29	33	33	20	45	26	41
Poor	17	15	16	18	14	10	10	20	13	27	20	23	29	18
Not sure	3	–	–	6	4	7	8	2	–	7	–	–	–	–
–––––Positive	45	40	44	52	54	49	51	49	53	33	60	32	45	41
–––––Negative	52	60	56	42	43	44	41	49	47	60	40	68	55	59
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.6.51

Table 3.14

PERCEPTION OF HOW WELL FASB CARRIES OUT ITS PRECEPTS: BREAKDOWN BY RESPONDENTS

Q.12C-2—How would you rate how well the FASB performs in carrying out the precepts (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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
To be objective in its decision making and to ensure the neutrality of information resulting from its standards														
Excellent	30	26	27	15	39	39	39	31	47	13	33	13	32	53
Pretty good	51	56	58	58	43	41	41	56	53	60	53	58	50	29
Only fair	11	9	6	21	11	12	10	7	–	7	13	26	8	18
Poor	4	8	6	3	4	–	–	2	–	7	–	3	11	–
Not sure	4	1	3	3	4	7	10	4	–	13	–	–	–	–
————Positive	81	82	85	73	82	80	80	87	100	73	87	71	82	82
————Negative	15	17	13	24	14	12	10	9	–	13	13	29	18	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
To weigh carefully the views of its constituents in developing concepts and standards, although the ultimate determinant must be the Board's judgment based on research, public input, and careful deliberation about the usefulness of resulting information														
Excellent	29	24	29	18	36	32	28	31	53	13	27	10	50	47
Pretty good	44	42	43	58	43	46	48	33	20	27	53	52	37	35
Only fair	20	26	22	21	14	12	13	29	27	40	20	35	11	18
Poor	3	4	5	–	4	2	–	4	–	13	–	3	3	–
Not sure	4	4	1	3	4	7	11	2	–	7	–	–	–	–
————Positive	73	67	72	76	79	78	75	64	73	40	80	61	87	82
————Negative	23	29	27	21	18	15	13	33	27	53	20	39	13	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
To promulgate standards only when the expected benefits exceed the perceived costs														
Excellent	7	1	1	3	14	7	15	7	20	–	–	–	13	24
Pretty good	38	36	37	30	36	49	34	42	33	47	47	26	47	47
Only fair	37	45	38	55	39	24	30	36	47	13	47	61	21	18
Poor	13	18	22	9	4	5	8	13	–	33	7	13	13	6
Not sure	5	–	3	3	7	15	13	2	–	7	–	–	5	6
————Positive	45	37	38	33	50	56	49	49	53	47	47	26	61	71
————Negative	50	63	59	64	43	29	38	49	47	47	53	74	34	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.6.52

Table 3.14 (continued)

PERCEPTION OF HOW WELL FASB CARRIES OUT ITS PRECEPTS: BREAKDOWN BY RESPONDENTS

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
To bring about needed changes in ways that minimize disruption to the continuity of reporting practices														
Excellent	14	8	14	3	25	15	21	13	20	–	20	6	11	29
Pretty good	50	54	49	55	54	54	34	51	67	27	60	48	66	41
Only fair	26	29	22	33	14	20	33	27	13	47	20	42	18	18
Poor	7	9	13	6	4	5	2	7	–	20	–	3	5	12
Not sure	3	–	3	3	4	7	10	2	–	7	–	–	–	–
—————Positive	64	62	63	58	79	68	56	64	87	27	80	55	76	71
—————Negative	33	38	34	39	18	24	34	33	13	67	20	45	24	29
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
To review the effects of past decisions														
Excellent	12	8	11	6	11	20	20	9	27	–	–	–	16	12
Pretty good	39	41	38	36	54	39	33	40	40	27	53	26	39	53
Only fair	31	32	28	45	18	20	20	36	33	40	33	55	37	24
Poor	9	10	18	6	–	10	5	9	–	13	13	10	8	6
Not sure	10	9	5	6	18	12	23	7	–	20	–	10	–	6
—————Positive	50	49	49	42	64	59	52	49	67	27	53	26	55	65
—————Negative	40	42	46	52	18	29	25	44	33	53	47	65	45	29
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.6.53

A Standards-Setting Process That Develops a Consensus And yet Is Consistent with a Conceptual Framework

A pivotal question that obviously must be asked is just how to set standards that are basically agreed upon by those who must live with them and yet, at the same time, to come up with a conceptual framework that provides for consistent standards within a meaningful conceptual framework. This comes close to the heart of the issue facing the FASB on a regular basis.

The survey asked about this central question in two parts: first asking if each element—consensus and consistency—was realistic and then whether each was desirable.

Table 4.15

HOW REALISTIC AND DESIRABLE IT IS TO HAVE A STANDARDS-SETTING PROCESS THAT ACHIEVES A CONSENSUS BUT ALSO HAS STANDARDS THAT ARE CONSISTENT WITH EACH OTHER AND WITH AN OVERRIDING CONCEPTUAL FRAMEWORK

Q.13G—Considering the interests of all those who are involved in and affected by financial reporting, do you feel that it is realistic or unrealistic to have a standards-setting process that (READ EACH ITEM)?

Q.13H—Now do you feel it is *desirable* or *undesirable* to have a standards-setting process that (READ EACH ITEM)?

	Q.13G			Q.13H		
	Realistic	Unrealistic	Not Sure	Desirable	Undesirable	Not Sure
	%	%	%	%	%	%
BASE: TOTAL RESPONDENTS—451						
1 Attempts to establish standards by developing a consensus among its constituents on specific issues, with solutions in accord with that consensus	69	29	2	78	18	2
2 Attempts to establish standards that are consistent with each other and with an overriding conceptual framework	82	14	3	90	6	2

Observation: *It is evident from those clear-cut results that it is viewed as both realistic and desirable to "establish standards by developing a consensus among its constituents on specific issues, with solutions in accord with that consensus" and at the same time to "establish standards that are consistent with each other and with an overriding conceptual framework." In turn, of course, this puts the question squarely up to the FASB to have both these basic conditions met within reasonable parameters in its standards-setting process. There has been essentially no change from 1980 in these results.*

[HARRIS]

18.R.54 Following is a breakdown by respondents on how realistic and desirable it is to set standards of financial accounting and reporting by attempting to establish a consensus among the Board's constituents and also by attempting to have those standards consistent with an overriding conceptual framework.

Table 4.16

HOW REALISTIC IT IS TO HAVE STANDARDS-SETTING PROCESS THAT ACHIEVES CONSENSUS AND IS CONSISTENT WITH CONCEPTUAL FRAMEWORK: BREAKDOWN BY RESPONDENTS

Q.13G—Do you feel that it is realistic or unrealistic to have a standards-setting process that (READ EACH ITEM)?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Attempts to establish standards by developing a consensus among its constituents on specific issues, with solutions in accord with that consensus														
Realistic	69	69	68	73	79	66	77	69	67	60	80	58	61	71
Unrealistic	29	27	29	24	21	32	20	31	33	40	20	42	39	29
Not sure	2	4	3	3	–	2	2	–	–	–	–	–	–	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–
Attempts to establish standards that are consistent with each other and with an overriding conceptual framework														
Realistic	82	86	76	85	86	83	85	82	87	87	73	87	71	88
Unrealistic	14	10	19	12	14	15	8	16	13	13	20	13	26	12
Not sure	3	4	5	3	–	2	5	2	–	–	7	–	3	–
No answer	*	–	–	–	–	–	2	–	–	–	–	–	–	–

*Less than .5%

[HARRIS]

18.2.55

Table 4.17

HOW DESIRABLE IT IS TO HAVE STANDARDS-SETTING PROCESS THAT ACHIEVES CONSENSUS AND IS CONSISTENT WITH CONCEPTUAL FRAMEWORK: BREAKDOWN BY RESPONDENTS

Q.13H—Do you feel that it is desirable or undesirable to have a standards-setting process that . (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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Attempts to establish standards by developing a consensus among its constituents on specific issues, with solutions in accord with that consensus														
Desirable	78	76	84	79	89	73	87	82	87	80	80	77	53	76
Undesirable	18	21	14	15	11	22	10	16	13	20	13	23	37	24
Not sure	2	1	3	3	–	2	2	2	–	–	7	–	3	–
No answer	2	3	–	3	–	2	2	–	–	–	–	–	8	–
Attempts to establish standards that are consistent with each other and with an overriding conceptual framework														
Desirable	90	92	86	88	93	90	92	91	93	93	87	94	89	94
Undesirable	6	1	10	6	7	7	3	7	7	7	7	6	3	6
Not sure	2	4	4	3	–	–	3	2	–	–	7	–	–	–
No answer	2	3	–	3	–	2	2	–	–	–	–	–	8	–

Finally, each respondent in the sample was asked what they would like personally to see emerge from the development of a conceptual framework:

Table 4.18

HOPES FOR AFFIRMATION OF STATUS QUO OR SIGNIFICANT CHANGES IN FINANCIAL REPORTING AS A RESULT OF EFFORTS TO COME UP WITH A CONCEPTUAL FRAMEWORK

Q 13I—Now, regardless of what you think will result from the conceptual framework, would you personally *like* to see it result *more* in an affirmation of the status quo with minor changes, or more in significant changes in financial reporting?

	1985	1980
	%	%
Affirmation of status quo with minor changes	59	51
Significant changes in financial reporting	31	39
Neither	4	4
Not sure	5	6

[HARRIS]

18.2.56 Following is the 1985 breakdown by categories of respondents.

Table 4.19

RESULTS OF CONCEPTUAL FRAMEWORK: BREAKDOWN BY RESPONDENTS

		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.				Total	Executive Partners	Technical Partners	Audit Partners			
BASE: TOTAL RESPONDENTS	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Affirmation of status quo with minor changes	59	72	76	42	57	54	67	58	60	53	60	58	26	29
Significant changes in financial reporting	31	19	18	55	18	44	21	33	33	27	40	26	66	65
Neither	4	5	1	–	11	2	3	2	7	–	–	16	5	–
Not sure	5	4	5	3	14	–	8	7	–	20	–	–	3	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *Even more than in 1980, a solid majority is looking for the work on a conceptual framework to come up with an affirmation of the status quo, albeit with some minor changes, instead of significant and sweeping changes in the way financial reporting is conducted.*

[HARRIS]

Responsiveness and Amount of Emphasis Given by FASB to Accounting Standards

18.C.57 When asked directly whether the FASB has been responsive to important changes in the financial reporting environment, these constituents and observers came down heavily on the side of saying the FASB has been responsive:

Table 5.6

RESPONSIVENESS OF FASB

BASE: TOTAL RESPONDENTS	Total Sample 451
	%
Responsive	80
Not responsive	14
Not sure	6

Following is a breakdown by respondents on whether they believe the FASB to be responsive to changes in the financial reporting environment.

Table 5.7

RESPONSIVENESS TO CHANGE IN FINANCIAL REPORTING ENVIRONMENT: BREAKDOWN BY RESPONDENTS

Q.14C—Do you feel the FASB is responsive to changes in the financial reporting environment?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Responsive	80	83	78	67	82	73	90	78	93	60	80	77	76	82
Not responsive	14	9	19	27	14	17	2	16	7	20	20	19	11	18
Not sure	6	6	1	6	4	10	8	7	–	20	–	–	13	–
No answer	1	1	1	–	–	–	–	–	–	–	–	3	–	–

[HARRIS]

18.e.58 Then they were asked to assess whether four areas of activity that might impact on adequate financial reporting were receiving too much, too little, or about the right amount of emphasis from the organizations responsible for those activities:

Table 5.8

AMOUNT OF EMPHASIS GIVEN TO ENSURE ADEQUATE FINANCIAL REPORTING ON ACCOUNTING STANDARDS, AUDITING STANDARDS, PROFESSIONAL ETHICS, AND REGULATORY ACTION

BASE: TOTAL RESPONDENTS—451	Too Much	Too Little	About Right	Not Sure
	%	%	%	%
Accounting standards	13	12	73	1
Auditing standards	8	28	61	3
Professional ethics	3	51	43	3
Regulatory action	44	9	42	5

Observation: *Here it is evident that fully 73% of these key constituents and observers are convinced that in the accounting standards area there is "the right amount of emphasis." This is almost matched by the 61% who feel the same about auditing standards, although 28% feel that there is too little emphasis on that area, mainly on the part of investment institutions, bank lending officers, and the financial media.*

By contrast, in the case of professional ethics, a substantial 51% overall feel there has been "too little" emphasis. Feeling most strongly about this are bank lending officers, technical and audit partners in large accounting firms, small accounting firms, academics, and financial media people.

On the other hand, a substantial 44% feel that in the area of regulatory action there has been too much emphasis, a criticism led by CEOs of large public companies and of private companies, partners in large accounting firms, and those running small accounting firms.

[HARRIS]

18.6.59 Following is a breakdown by respondents on the data contained in Table 5.8.

Table 5.9

AMOUNT OF EMPHASIS IN FINANCIAL REPORTING: BREAKDOWN BY RESPONDENTS

Q 14D—Accounting standards are only one means of ensuring adequate financial reporting in the public interest. The other principal ones are auditing standards, professional and ethical standards, and regulatory action. Do you believe there is too much, too little, or the right amount of emphasis on . . . (READ EACH ITEM)?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Accounting standards														
Too much	13	18	15	15	14	12	–	20	13	27	20	16	13	6
Too little	12	6	11	15	11	20	13	11	7	13	13	10	11	35
About right	73	76	73	70	75	66	87	67	80	53	67	71	74	59
Not sure	1	–	–	–	–	2	–	2	–	7	–	3	3	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Auditing standards														
Too much	8	12	11	3	18	5	2	7	7	13	–	10	5	6
Too little	28	21	25	39	21	41	46	20	13	40	7	10	16	47
About right	61	65	61	58	54	51	51	71	80	47	87	77	66	47
Not sure	3	3	3	–	7	2	2	2	–	–	7	3	13	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Professional ethics														
Too much	3	4	5	3	–	2	5	2	–	7	–	–	3	–
Too little	51	45	28	45	46	54	61	60	47	67	67	61	68	71
About right	43	47	65	52	50	39	33	36	47	27	33	39	24	24
Not sure	3	4	3	–	4	5	2	2	7	–	–	–	5	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Regulatory action														
Too much	44	56	46	33	54	32	43	60	53	67	60	48	21	24
Too little	9	4	5	12	4	7	13	7	–	13	7	6	13	35
About right	42	36	47	52	32	56	39	24	33	7	33	45	55	41
Not sure	5	4	3	3	11	5	5	9	13	13	–	–	11	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.6.60 **Does the FASB Listen Carefully Enough to the Views of Its Constituencies?**

Over the past few years, the claim has been made that the FASB simply does not listen carefully enough to the views of its diverse constituencies. The sample was asked bluntly, "Do you feel that criticism is justified?"

Table 5.10

WHETHER FASB LISTENS CAREFULLY TO ITS CONSTITUENTS

Q 15A—The criticism has been made that the FASB does not listen carefully enough to the views of its diverse constituents. Do you feel that criticism is justified?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Justified	37	49	42	36	21	32	36	40	27	53	40	48	13	29
Not justified	50	49	52	45	61	46	31	58	73	40	60	32	79	53
Not sure	13	3	6	18	18	22	33	2	–	7	–	19	8	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *By a clear 50-37%, most feel that the criticism of the FASB that it does not listen to its key constituencies is unjustified. In only one case, technical partners of large accounting firms where a 53-40% majority feels the charges are justified, does a majority share in the criticism. Pluralities of bank lending officers and small accounting firms feel the same. CEOs of large public companies are split down the middle, 49-49% on this issue. By clear-cut margins, all of the other groups surveyed disagree with these minorities.*

When asked if they could cite any specific case where the FASB has not listened carefully enough, 37% said they could, with a higher 56% of CEOs of large public companies and 51% of CFOs of such companies who said they could give examples:

Table 5.11

WHETHER RESPONDENTS CAN CITE CASES WHERE FASB DID NOT LISTEN CAREFULLY TO CONSTITUENTS

Q 15B—Can you cite any specific case where the FASB did not listen carefully enough?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Can list such a case	37	56	51	39	29	22	16	36	40	33	33	35	21	35
Cannot	60	41	47	61	61	78	77	62	60	60	67	65	71	59
Not sure	4	3	3	–	11	–	7	2	–	7	–	–	8	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.2.61. Following is a breakdown by total respondents on cases that were cited as examples where the FASB did not listen carefully enough to the views of its constituents.

Table 5.13

CASES WHERE FASB DID NOT LISTEN TO CONSTITUENTS: BREAKDOWN BY RESPONDENTS

Q.15C—What case can you cite? Base: Examples where FASB didn't listen carefully enough

		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	165	44	40	13	8	9	10	16	6	5	5	11	8	6
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Pension accounting	27	34	33	8	50	11	–	44	50	40	40	18	13	–
Inflation accounting	18	30	30	8	13	11	10	–	–	–	–	–	–	–
Lease accounting	12	9	23	–	–	–	–	31	33	40	20	–	13	–
Foreign currency translation	13	11	8	8	–	33	40	–	–	–	–	–	50	17
Changing prices	4	9	–	8	13	–	–	–	–	–	–	–	–	17
Current cost	2	2	3	–	–	22	–	–	–	–	–	–	–	–
Income tax accounting	6	2	5	8	–	11	–	13	–	20	20	18	–	17
Conceptual framework	2	5	3	–	–	–	–	–	–	–	–	–	–	–
Loan origination fees	2	5	3	–	–	–	10	–	–	–	–	–	–	–
Restriction of debt	1	–	3	–	–	11	–	–	–	–	–	–	–	–
Handling of acquisitions	3	5	3	8	–	–	10	–	–	–	–	–	–	–
Oil and gas controversy	3	2	3	8	–	–	–	–	–	–	–	–	25	–
Not recognizing small company reporting	7	–	3	15	–	–	–	6	17	–	–	55	–	17
FASB #33 (Financial Reporting and Changing Prices)	4	2	10	8	–	–	–	–	–	–	–	–	–	–
FASB #52 (Foreign Currency Translation)	2	5	3	–	–	–	–	–	–	–	–	–	–	–
FASB #71 (Accounting for the Effects of Certain Types of Regulation)	1	–	5	–	–	–	–	–	–	–	–	–	–	–
FASB #8 (Accounting for the Translation of Foreign Currency Transactions and Financial Statements)	4	7	3	8	–	–	–	–	–	–	–	–	13	–
Any other mentions	27	18	28	23	25	11	40	44	33	40	60	36	25	50
Don't know/ no answer	1	–	3	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.2.63 Following is a breakdown by respondents of the importance of the 11 key groups noted in Table 5.14.

Table 5.15

IMPORTANCE OF 11 KEY GROUPS: BREAKDOWN BY RESPONDENTS

Q.16—How important do you feel it is for the FASB to pay attention to the . . . (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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Financial Accounting Standards Advisory Council of the FASB														
Very important	53	53	56	58	64	54	64	42	60	47	20	42	42	41
Somewhat important	35	35	37	27	32	32	28	33	20	40	40	42	53	47
Not very important	4	4	3	3	4	5	2	13	20	–	20	6	5	–
Not important at all	*	–	1	–	–	–	–	2	–	–	7	–	–	–
Not sure	7	9	4	12	–	10	7	9	–	13	13	10	–	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Small Business Advisory Group of the FASB														
Very important	44	28	27	58	39	39	49	67	73	67	60	90	37	35
Somewhat important	40	49	56	33	54	39	39	18	13	20	20	10	42	41
Not very important	10	10	11	3	7	12	7	11	13	7	13	–	21	6
Not important at all	1	3	1	–	–	2	–	2	–	–	7	–	–	–
Not sure	5	10	5	6	–	7	5	2	–	7	–	–	–	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Emerging Issues Task Force of the FASB														
Very important	63	62	67	61	43	59	57	69	73	67	67	71	63	76
Somewhat important	31	33	22	24	54	32	38	29	27	27	33	23	32	24
Not very important	2	–	8	–	4	2	2	–	–	–	–	–	5	–
Not important at all	2	3	3	6	–	5	–	–	–	–	–	–	–	–
Not sure	3	3	1	9	–	2	3	2	–	7	–	6	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Accounting Standards Executive Committee of the AICPA														
Very important	50	45	49	45	64	54	54	62	73	67	47	52	29	41
Somewhat important	40	42	46	39	32	39	33	31	20	20	53	42	55	41
Not very important	4	4	3	–	4	5	7	4	7	7	–	3	13	–
Not important at all	1	3	–	–	–	–	–	–	–	–	–	–	–	6
Not sure	5	6	3	15	–	2	7	2	–	7	–	3	3	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

Table 5.15 (continued)

18.e.64

IMPORTANCE OF 11 KEY GROUPS: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Committee on Corporate Reporting of the FEI														
Very important	36	54	42	33	39	24	38	24	40	20	13	29	21	29
Somewhat important	49	32	51	45	50	51	48	58	60	53	60	61	58	47
Not very important	6	4	6	3	4	10	3	7	–	7	13	6	16	6
Not important at all	1	1	–	–	–	2	–	–	–	–	–	–	3	6
Not sure	8	9	1	18	7	12	11	11	–	20	13	3	3	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Management Accounting Practices Committee of the NAA														
Very important	24	24	20	45	21	29	30	16	13	20	13	10	18	35
Somewhat important	47	44	57	27	50	44	48	58	60	60	53	55	32	35
Not very important	17	17	15	12	21	7	10	18	27	7	20	26	39	6
Not important at all	4	6	3	3	–	5	–	4	–	–	13	6	8	12
Not sure	8	9	5	12	7	15	13	4	–	13	–	3	3	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Financial Accounting Policy Committee of the Financial Analysts Federation														
Very important	22	13	16	24	11	46	38	13	20	20	–	–	24	47
Somewhat important	53	54	58	45	50	44	38	56	60	53	53	84	53	47
Not very important	15	17	19	15	21	5	10	22	13	13	40	13	18	–
Not important at all	2	10	1	–	–	–	–	–	–	–	–	–	–	6
Not sure	8	6	5	15	18	5	15	9	7	13	7	3	5	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Accounting Policies Committee of Robert Morris Associates														
Very important	14	5	3	3	4	7	59	13	13	20	7	3	13	24
Somewhat important	30	26	32	12	29	32	28	31	40	13	40	55	26	41
Not very important	24	29	32	12	18	12	5	31	27	47	20	32	42	12
Not important at all	8	9	1	12	11	15	3	16	20	–	27	6	8	–
Not sure	25	31	33	61	39	34	5	9	–	20	7	3	11	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

Table 5.15 (continued)

18.2.65 **IMPORTANCE OF 11 KEY GROUPS: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Financial Accounting Standards Committee of the American Accounting Association														
Very important	19	15	9	24	14	24	36	20	20	20	20	–	29	24
Somewhat important	53	46	63	45	46	54	44	60	67	60	53	74	50	41
Not very important	16	22	16	9	21	10	8	16	13	7	27	26	13	12
Not important at all	3	5	4	3	4	2	–	–	–	–	–	–	5	6
Not sure	9	12	8	18	14	10	11	4	–	13	–	–	3	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Accounting Principles Task Force of the Business Roundtable														
Very important	22	33	22	33	11	17	33	9	7	13	7	10	11	18
Somewhat important	49	49	52	30	57	49	43	56	60	47	60	55	45	53
Not very important	15	10	15	12	18	12	10	13	13	7	20	26	29	12
Not important at all	3	3	–	–	4	15	–	4	–	13	–	–	5	6
Not sure	12	5	11	24	11	7	15	18	20	20	13	10	11	12
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Securities and Exchange Commission														
Very important	63	64	61	64	64	59	54	78	93	67	73	45	68	76
Somewhat important	31	31	33	30	32	27	33	20	7	33	20	48	29	24
Not very important	4	3	6	6	4	5	8	2	–	–	7	3	3	–
Not important at all	1	1	–	–	–	7	2	–	–	–	–	3	–	–
Not sure	1	1	–	–	–	2	3	–	–	–	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.e.67 Indeed, the survey put directly to the sample a question asking them just how effective they thought the approximately 85 Statements issued by the FASB have been.

Table 6.4

HOW EFFECTIVE TOTAL OUTPUT OF FASB HAS BEEN TO DATE

Q 17C—Out of the total of about 85 Statements issued up to now, a few, such as those we've been discussing, have been more widely publicized than most of the others, because they were viewed as controversial. Taking into consideration the total output of the FASB to date, do you think its standards are highly effective, somewhat effective, not very effective, or not effective at all in improving financial reporting?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Highly effective	37	37	34	48	32	29	41	42	60	20	47	39	34	24
Somewhat effective	57	54	59	42	64	66	57	53	40	67	53	61	58	59
Not very effective	5	9	5	6	4	5	–	–	–	–	–	–	8	18
Not effective at all	*	–	–	3	–	–	–	2	–	7	–	–	–	–
Not sure	1	–	1	–	–	–	2	2	–	7	–	–	–	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%.

Observation: *By a high 94-5%, the vast majority is willing to call the FASB Statements effective. By any measure, this is a most positive endorsement of the main efforts of FASB by those most affected by them.*

People were then further asked to explain why the FASB Statements are generally accepted:

Table 6.5

WHY FASB STATEMENTS ARE GENERALLY ACCEPTED

BASE: TOTAL RESPONDENTS—451	Are	Are Not	Not Sure
	%	%	%
1 In view of the enforcement power of the SEC and the AICPA	88	8	3
2 Because, by and large, they improve generally accepted accounting principles	73	22	5
3 Because they represent the private sector's only hope to retain self-regulation of financial reporting	65	30	5

Observation: *Obviously, the prevailing view is that the FASB system of developing Statements represents close to the best of all alternatives that might be available for bringing order into the realm of accounting and financial reporting in the United States.*

[HARRIS]

18.6.68 Following is a breakdown by respondents of why they believe FASB Statements are generally accepted.

Table 6.6

ACCEPTABILITY OF FASB STANDARDS: BREAKDOWN BY RESPONDENTS

Q.17D—As far as acceptability of FASB standards is concerned, do you feel they are usually accepted . (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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Because, by and large, they improve generally accepted accounting principles														
Are	73	69	70	88	75	78	79	73	80	73	67	74	63	65
Are not	22	27	27	12	25	17	11	20	20	7	33	26	29	29
Not sure	5	4	4	–	–	5	10	7	–	20	–	–	8	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
In view of the enforcement powers of the SEC and the AICPA														
Are	88	88	94	88	86	83	89	87	87	80	93	94	79	88
Are not	8	9	5	12	14	7	10	4	–	7	7	3	13	12
Not sure	3	3	1	–	–	10	2	9	13	13	–	3	5	–
No answer	*	–	–	–	–	–	–	–	–	–	–	–	3	–
Because they represent the private sector's only hope to retain self-regulation of financial reporting														
Are	65	76	63	70	64	59	61	58	47	53	73	58	71	65
Are not	30	21	35	24	32	32	31	33	40	33	27	42	21	35
Not sure	5	4	1	6	4	10	8	9	13	13	–	–	8	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than .5%

[HARRIS]

18.2.69

Table 6.7

WHETHER ECONOMIC INTERESTS AFFECT ACCEPTABILITY OF FASB STANDARDS

Q 17E—By and large do you agree or disagree with the statement that, in general, FASB standards are acceptable to most people unless their economic interests are adversely affected?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Agree	82	79	78	79	82	90	90	64	73	60	60	87	92	88
Disagree	16	21	20	21	18	7	8	29	20	27	40	10	3	12
Not sure	2	–	1	–	–	2	2	7	7	13	–	3	5	–
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Assessing the Performance of the FASB

Throughout this report, it has been evident that perhaps the major problem facing the Financial Accounting Standards Board is how to achieve a consistent and coherent system of accounting practices that will bring order and responsibility to financial reporting but at the same time also will take into account the highly practical problems of implementation.

The sample of key constituents and observers was asked about this delicate balance directly.

Table 6.8

IN ITS DECISIONS, DOES THE FASB ACHIEVE THE NECESSARY BALANCE TO GET THE JOB DONE?

Q 17G—In its decision making, the Board must resolve complex technical issues without losing sight of practical implementation problems. Do you feel that in its decisions up to now the Board has (READ EACH ITEM), or hasn't it?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Stressed technically correct solutions at the expense of practical considerations														
Has	50	62	57	45	50	41	44	53	40	53	67	68	16	41
Has not	41	36	39	39	43	46	38	42	53	40	33	26	74	35
Not sure	9	3	4	15	7	12	18	4	7	7	–	6	11	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

18.R.70

Table 6.8 (continued)

IN ITS DECISIONS, DOES THE FASB ACHIEVE THE NECESSARY BALANCE TO GET THE JOB DONE?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Responded to practical considerations at the expense of technical correctness														
Has	20	12	18	24	14	22	20	18	13	7	33	13	45	24
Has not	71	86	77	64	75	63	59	78	80	87	67	84	47	53
Not sure	9	3	5	12	11	15	21	4	7	7	–	3	8	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Achieved a sensible balance between technical and practical considerations														
Has	54	60	59	58	50	63	57	38	60	27	27	32	61	41
Has not	35	36	35	21	39	24	23	53	33	60	67	61	29	35
Not sure	11	4	5	21	11	12	20	9	7	13	7	6	11	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *Here it is evident that if the FASB is perceived as having a tilt it is toward being more technically correct than responsive to practical considerations. For example, by 50-41%, a plurality feels that the Board "has stressed technically correct solutions at the expense of practical considerations." This criticism is felt most strongly by CEOs and CFOs of large public companies, by audit partners of large accounting firms, and heads of small accounting firms. By the same token, a big 71-20% majority denies that the FASB "has responded to practical considerations at the expense of technical correctness," a clear indication that perceived pragmatism has not taken over at the Board.*

But then, when asked to weigh the matter still more, a clear 54-35% majority believes that the FASB "has achieved a sensible balance between technical and practical considerations." Notably, a 60-36% majority of CEOs of large companies and a 59-35% majority of CFOs from similar companies share this view. The implication is that if the Board should lean over backward in any area, it should be to make certain it is technically correct.

[HARRIS]

18.2.7/ The sample was asked on an up or down basis a series of specific questions that dealt with common criticisms of the FASB head on:

Table 6.9

TESTING CRITICISMS OF THE FASB

Q 18A—In general do you find the FASB (READ EACH ITEM), or not?

	1985			1980		
	Does	Does Not	Not Sure	Does	Does Not	Not Sure
	%	%	%	%	%	%
Deals with the right issues	70	21	9	63	18	20
Responds to emerging issues as they arise	57	35	8	55	29	17
Is sufficiently responsive to requests to reconsider standards	42	23	35	*	*	*
Moves fast enough on major issues	41	54	6	41	39	20
Promulgates too many new standards	37	55	7	34	51	15
Is sufficiently responsive to the needs of small business	28	45	27	12	50	38

*This was not a question in the 1980 survey.

Observation: *It is evident that the FASB has by no means dispelled all of the common criticisms of the way it conducts its business. It is not thought to move fast enough on major issues and is not viewed as sufficiently responsive to the needs of small business. In the case of small business, however, there has been a 16-point improvement in the FASB's perceived performance, although 45% still are critical of the Board in this respect.*

Following is the 1985 breakdown by categories of respondents.

Table 6.10

TESTING CRITICISMS OF THE FASB: BREAKDOWN BY RESPONDENTS

Q 18A—Do you find that the FASB . . . (READ EACH ITEM)?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Moves fast enough on major issues														
Does	41	42	42	30	43	34	43	40	53	20	47	55	39	29
Does not	54	55	58	64	46	56	41	56	47	67	53	42	55	71
Not sure	6	1	–	6	11	10	16	4	–	13	–	3	5	–
No answer	*	1	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

Table 6.10 (continued)

18.8.72 **TESTING CRITICISMS OF THE FASB: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Responds to emerging issues as they arise														
Does	57	68	56	45	57	56	52	53	73	27	60	58	55	59
Does not	35	31	39	39	36	41	26	42	27	60	40	39	32	35
Not sure	8	1	5	15	7	2	21	4	–	13	–	3	13	6
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Deals with the right issues														
Does	70	68	62	85	79	78	75	76	93	60	73	71	47	65
Does not	21	27	33	3	14	15	7	22	7	33	27	16	29	29
Not sure	9	5	5	12	7	7	18	2	–	7	–	10	21	6
No answer	*	–	–	–	–	–	–	–	–	–	–	3	3	–
Promulgates too many new standards														
Does	37	42	43	30	32	32	25	38	27	47	40	48	50	18
Does not	55	53	52	61	54	56	62	60	73	47	60	48	45	71
Not sure	7	5	5	9	14	10	13	2	–	7	–	3	3	12
No answer	*	–	–	–	–	2	–	–	–	–	–	–	3	–
Is sufficiently responsive to the needs of small business														
Does	28	22	24	30	29	44	41	20	20	13	27	10	37	18
Does not	45	37	32	58	46	17	41	76	73	80	73	90	47	29
Not sure	27	41	44	12	25	39	18	4	7	7	–	–	16	53
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Is sufficiently responsive to requests to reconsider standards														
Does	42	44	41	39	46	41	34	47	53	27	60	32	53	47
Does not	23	28	33	18	7	15	18	29	27	40	20	26	11	24
Not sure	35	28	27	42	46	44	48	24	20	33	20	42	37	29
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

*Less than 5%

[HARRIS]

18.?.73 But is there a sense that progress is being made? Again, a series of questions was asked to measure that.

Table 6.11

FASB TODAY COMPARED WITH FIVE YEARS AGO

Q 18C—Compared with five years ago, would you say the FASB today is more (READ EACH ITEM), less, or not much different than it was then?

BASE: TOTAL RESPONDENTS—451	More	Less	Not Much Different	Not Sure
	%	%	%	%
Responsive to new or emerging needs for standards	59	3	30	8
Strong overall as an institution	46	8	39	8
Responsive to a variety of points of view	43	3	43	11
Effective in setting standards	33	8	51	8
Successful in achieving a sensible balance between technical and practical considerations	26	14	51	9

Observation: *Significantly, in no case do more than 14% think the FASB has regressed. Indeed, in every one of the five pivotal areas tested, there are far more who feel the Board has made progress than believe it has gone backward. This is a definite sign that the FASB is felt to have essentially positive momentum.*

Following is a breakdown by respondents comparing the FASB with five years ago.

Table 6.12

FASB COMPARED WITH FIVE YEARS AGO: BREAKDOWN BY RESPONDENTS

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Responsive to a variety of points of view														
More	43	41	43	48	39	37	46	47	53	33	53	52	39	24
Less	3	5	9	3	–	2	2	–	–	–	–	–	–	–
Not much different	43	47	43	42	43	41	34	49	47	53	47	29	50	53
Not sure	11	6	5	6	18	20	18	4	–	13	–	19	11	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Responsive to new or emerging needs for standards														
More	59	62	62	52	64	51	59	64	73	47	73	48	63	41
Less	3	–	8	3	4	–	–	2	–	7	–	6	3	–
Not much different	30	35	28	33	25	34	23	31	27	40	27	35	29	35
Not sure	8	4	3	12	7	15	18	2	–	7	–	10	5	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

[HARRIS]

Table 6.12 (continued)

18.8.74 **FASB COMPARED WITH FIVE YEARS AGO: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Effective in setting standards														
More	33	26	33	33	32	44	38	36	40	20	47	35	26	29
Less	8	9	9	9	14	7	2	2	7	–	–	10	18	6
Not much different	51	60	56	48	46	39	44	58	53	67	53	48	47	41
Not sure	8	5	3	9	7	10	16	4	–	13	–	6	8	24
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Successful in achieving a sensible balance between technical and practical considerations														
More	26	28	27	27	14	39	34	18	27	13	13	19	21	12
Less	14	13	20	15	11	10	8	9	–	20	7	19	18	6
Not much different	51	54	51	48	64	34	41	69	73	53	80	52	50	53
Not sure	9	4	3	9	11	17	16	4	–	13	–	10	11	29
No answer	*	1	–	–	–	–	–	–	–	–	–	–	–	–
Strong overall as an institution														
More	46	41	52	52	50	51	49	38	27	40	47	48	32	41
Less	8	13	10	9	–	5	–	7	7	13	–	16	11	–
Not much different	39	42	37	33	36	24	34	51	60	40	53	35	53	35
Not sure	8	4	1	6	14	17	16	4	7	7	–	–	5	24
No answer	*	–	–	–	–	2	–	–	–	–	–	–	–	–

*Less than .5%.

[HARRIS]

18.2.15 Perhaps the most serious charge against the FASB is that it moves too slowly into the breech in promulgating standards and in considering emerging problems. This criticism was put to a kind of bottom-line test, as it was in 1980.

Table 6.13

PACE OF CHANGE IN PRACTICES INTRODUCED BY THE FASB

Q 17F—In general, do you feel the pace of change in practices introduced by the FASB is too rapid, too slow, or about right?

	1985	1980
	%	%
Too rapid	12	18
Too slow	34	19
About right	50	48
Not sure	4	15

Table 6.14

PACE OF CHANGE INTRODUCED BY FASB: 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Too rapid	12	17	11	3	14	5	13	18	7	27	20	23	5	6
Too slow	34	32	34	48	32	37	30	31	20	40	33	19	39	53
About right	50	49	52	42	50	49	52	49	73	27	47	52	55	41
Not sure	4	3	3	3	4	10	5	2	–	7	–	6	–	–
No answer	*	–	–	3	–	–	–	–	–	–	–	–	–	–

*Less than 5%.

Observation: *There is little doubt from this result that if the FASB errs, it is obviously on the side of being too cautious and too slow in making change. By the same token, however, it is far more significant that, by 62-34%, a sizable majority is prepared not to go along with the charge that the FASB's pace of change has been "too slow." Given the impact of its Statements and need for orderly change across a wide spectrum of financial activity and the entire financial reporting community, the considered judgment of these constituent groups and observers is that the FASB is moving within the parameter of a rate of change that is certainly acceptable.*

[HARRIS]

18.8.76 The other bottom-line consideration, of course, is just how responsive the FASB is to its own constituents. This was asked about directly in this year's study:

Table 6.15

FASB RESPONSIVENESS TO CONSTITUENT CONCERNS

Q.18B—Do you feel the FASB is sufficiently responsive to the concerns of its constituents?

	Total	Large Public Companies: Chief Executive 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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Sufficiently responsive	69	71	68	73	75	78	62	60	87	40	53	61	74	65
Not responsive	20	24	25	21	11	10	20	31	7	47	40	23	5	18
Not sure	11	5	6	6	14	12	16	9	7	13	7	16	18	12
No answer	1	–	–	–	–	–	2	–	–	–	–	–	3	6

Observation: *Earlier it was seen clearly that the FASB is widely viewed as being the epitome of technical correctness in its deliberations and its output. The question then remaining was whether the Board had become so inured with the notion of being technically correct that it had lost sight of the practical implementation problems facing its constituents. Not only do most think a proper balance has been struck by the FASB but also that the Board has been sufficiently responsive to the concerns of its constituents. In the end, then, a sizable majority is convinced that this delicate process does indeed work.*

The Overall Rating for the FASB

Certainly one of the key measurements in this 1985 study, as it was in 1980, is the overall rating accorded the FASB for its performance in carrying out its standards-setting mandate.

Table 6.16

TREND OF OVERALL RATING FOR FASB

Q.18F—All in all, how would you rate the job the FASB is doing in carrying out its standards-setting mandate—excellent, pretty good, not so good, or poor?

	1985	1980
	%	%
Excellent	15	11
Pretty good	73	62
Not so good	9	9
Poor	2	5
Not sure	2	12
———Positive	87	73
———Negative	11	14

[HARRIS]

18.2.77 Here is a breakdown of these same results by key groups who were surveyed:

Table 6.17

OVERALL RATING OF FASB FOR 1985

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Excellent	15	15	15	6	18	12	13	13	27	7	7	10	26	18
Pretty good	73	69	72	85	68	83	77	71	73	60	80	74	61	65
Not so good	9	10	11	6	11	2	3	11	–	20	13	13	8	18
Poor	2	4	1	–	–	–	–	2	–	7	–	3	5	–
Not sure	2	1	–	3	4	2	7	2	–	7	–	–	–	–
———Positive	87	85	87	91	86	95	90	84	100	67	87	84	87	82
———Negative	11	14	13	6	11	2	3	13	–	27	13	16	13	18
No answer	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Observation: *At a time when any positive overall rating between 50% and 60% is viewed as unusual and a real measure of success, the rise for the FASB from 73% to 87% positive over the past five years must be considered close to one of a kind.*

Following are tables giving respondents' views on the main improvements made by the FASB in financial reporting and what respondents believe are the Board's main shortcomings.

Table 6.18

IMPROVEMENTS MADE BY FASB

Q.18D—What are the main improvements you feel the FASB has made in carrying out its standards-setting mandate?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
They solicit input from larger segment of community/seek more comments/insights	7	10	8	3	7	5	3	9	13	7	7	6	5	6
They set up a conceptual framework/structure/system	6	9	6	3	4	2	–	2	–	–	7	10	21	6

[HARRIS]

18.2.78

Table 6.18 (continued)

IMPROVEMENTS MADE BY FASB

	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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
More active/agressive on issuing new standards	3	5	3	9	–	–	3	2	–	–	7	–	8	–
More receptive/open/they listen more	7	15	8	–	–	2	7	11	7	7	20	3	–	6
More responsive to business community	3	3	3	9	7	5	–	4	–	7	7	–	3	–
More practical/realistic decisions/standards	3	–	1	–	4	–	8	2	–	7	–	6	5	–
More open in decision-making process/consider all sides	2	–	5	–	–	2	2	2	–	–	7	–	–	–
They publicize/explain decisions better	3	4	3	–	–	2	3	7	–	–	20	3	–	–
They're considering every new issue more than they used to	2	1	4	–	–	2	5	4	13	–	–	–	–	6
More experienced/mature	*	–	1	–	–	–	–	–	–	–	–	3	–	–
Standards emerge firm in decisions	–	–	–	–	–	–	–	–	–	–	–	–	–	–
More uniformity	3	3	–	6	–	–	5	2	7	–	–	6	11	–
More positive reaction to SEC	2	–	3	6	–	–	–	2	7	–	–	3	3	–
More relevant	*	–	–	–	–	–	3	–	–	–	–	–	–	–
They're getting more respect/support from business community	1	–	5	–	–	2	–	–	–	–	–	–	–	–
They're concerned about economic realities/responding to shifting economic needs	1	–	–	–	–	2	2	–	–	–	–	–	3	6
Improved/corrected abuses in reporting practices/more complete/reliable reports/more thorough	2	1	1	9	–	–	3	–	–	–	–	3	–	–

[HARRIS]

18.8.79

Table 6.18 (continued)

IMPROVEMENTS MADE BY FASB

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Clearer regulations/improved standards/logical approach to standards	1	3	1	3	–	–	–	2	7	–	–	–	–	–
They're aware of a need for change/willing to reevaluate past decisions	3	4	4	–	4	–	3	–	–	–	–	6	–	12
Inflation accounting	1	–	1	–	4	–	2	–	–	–	–	3	3	6
They have established credibility/achieved acceptance	2	1	4	3	7	–	2	–	–	–	–	3	3	–
They're better/an improvement over their predecessor (APB)	1	–	4	–	4	–	–	–	–	–	–	3	–	–
Has maintained its independence	*	–	–	–	–	–	–	–	–	–	–	–	5	–
Getting out pronouncements on a timely basis	9	6	13	6	11	7	7	13	13	20	7	16	3	18
Higher quality of staff	2	1	–	–	–	–	–	7	7	7	7	3	3	6
Responsible for higher professionalism in the industry/improvement of professional standards	1	1	1	–	–	2	–	2	7	–	–	–	–	–
Emerging Issues Task Force	12	12	20	–	14	7	7	22	27	13	27	13	11	12
Recognizing smaller/private industry	2	1	–	3	4	2	2	2	7	–	–	6	–	6
Addressing more issues	1	1	3	–	–	–	–	–	–	–	–	–	–	–
Improved communications	2	4	4	–	4	5	–	2	–	7	–	3	–	–
Willing to address major/tough/difficult issues/keeping informed/publicity	4	5	4	–	7	–	8	4	13	–	–	–	3	6
Use of Technical Bulletins	2	3	1	–	–	–	–	9	13	–	13	3	–	6

[HARRIS]

18.E.80

Table 6.18 (continued)

IMPROVEMENTS MADE BY FASB

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Not qualified to answer/have no basis for opinion	2	1	–	6	4	–	7	2	–	7	–	–	–	–
None/no improvement/has deteriorated	13	22	13	6	21	12	3	11	7	7	20	16	21	–
All other mentions	13	10	13	12	–	15	18	11	13	7	13	3	26	18
Don't know/ no answer	20	15	14	39	18	34	26	11	7	27	–	19	8	24

*Less than .5%.

Table 6.19

SHORTCOMINGS OF THE FASB

Q 18E—What do you feel are the main shortcomings of the FASB in carrying out its standards-setting mandate?

		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
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
They're not fast enough	26	26	32	27	25	37	25	20	13	20	27	13	18	35
Oriented toward large businesses/ failure to consider small businesses	9	3	3	6	4	–	2	29	7	33	47	55	5	6
Dominated by the SEC	2	–	6	–	–	–	2	2	–	–	7	3	3	–
Should get more input/response/ backup material	4	4	4	6	–	5	2	4	–	7	7	6	3	–
Pronouncements need more interpretation/ unclear	2	3	3	–	4	5	3	–	–	–	–	–	5	–
Too theoretical/ not practical	9	14	13	3	7	7	15	4	–	7	7	3	–	–
Tries to cover too much ground	4	10	8	–	–	2	2	–	–	–	–	3	–	6

[HARRIS]

18.8.81

Table 6.19 (continued)

SHORTCOMINGS OF THE FASB

BASE: TOTAL 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
	451	78	79	33	28	41	61	45	15	15	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Too technical	4	6	8	3	–	2	7	2	–	–	7	–	5	–
Standards not clearly written	1	1	1	–	–	2	–	2	–	7	–	–	–	–
Too political	1	1	1	–	–	–	–	–	–	–	–	–	11	–
Too difficult to understand for non-accountants	1	–	3	–	–	–	3	2	–	–	7	–	–	–
Too many changes	1	1	1	–	–	–	–	–	–	–	–	3	–	–
Lack of flexibility/too rigid/too formalistic/too specific	6	8	8	6	7	2	2	4	7	–	7	13	11	–
Tries to reduce all accounting practices to universal standards/doesn't recognize major differences in industries	4	1	5	6	11	2	2	7	–	20	–	3	3	6
Lack of understanding/analysis/evaluation of problems/situation	1	–	–	–	–	–	2	–	–	–	–	3	3	–
Inability to develop a basic conceptual framework	4	8	3	–	4	–	2	2	–	–	7	–	13	–
Displeased with FASB #8 (Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements)	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Problems with making people/accountants comply with regulations	1	1	–	3	4	–	2	–	–	–	–	–	3	6
Lack of communications with financial community	1	–	3	3	–	–	–	–	–	–	–	–	–	–
Getting acceptance/respect from financial community	*	–	–	–	–	–	–	–	–	–	–	3	3	–
Too fast/FASB rushes into decisions	2	5	3	3	4	–	–	–	–	–	–	–	–	–

[HARRIS]

18.2.83

Table 6.19 (continued)

SHORTCOMINGS OF THE FASB

	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	[illegible]	15	31	38	17
	%	%	%	%	%	%	%	%	%	%	%	%	%	%
Influenced by special interest groups (Wall St., academia, affected industries)	4	4	4	3	7	–	2	4	–	7	7	3	13	6
Relates only to specific industry/small number of industries/too many specialized principles/specific problems of only small number of companies/not focused on more general/broader level	4	6	3	–	7	–	–	4	13	–	–	10	8	18
Not addressing specific issue (all mentions)	4	4	6	–	7	5	2	2	–	–	7	6	3	6
Inability to deal with major issues/decisions (income taxes, leasing, new products)	4	3	5	12	4	7	–	4	7	7	–	–	8	–
Inadequate public relations/publicity	1	1	–	3	4	–	2	2	7	–	–	–	–	–
Balancing cost vs. benefits derived	1	3	3	–	–	–	2	–	–	–	–	–	–	–
Strong CPA/accounting professional membership	1	4	–	3	–	–	–	–	–	–	–	–	3	–
None/not aware of any	5	5	5	3	–	2	13	4	13	–	–	–	–	6
All other mentions	23	29	18	12	29	24	21	20	40	7	13	6	34	41
Don't know/no answer	12	8	10	21	7	22	21	7	7	13	–	10	5	12

*Less than .5%.

[HARRIS]

19. Financial Instruments and Off-Balance-Sheet Financing

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	☐

19. Financial Instruments and Off-Balance-Sheet Financing

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]**

- Additional disclosure of risks and uncertainties, commitments, and off-balance-sheet transactions should be made in the financial statements. [Also included in 9 and 10] **[FASOversight, p. 2]**

[Context] The AIMR position paper provides a summary of the section (pages 11-20) entitled "The Changing World and Its Implications for Analysis," which describes the effects on financial analysis and financial reporting of three major phenomena:

The world constantly is changing and everyone must adjust to accommodate those forces over which they have no control. The nature and implications of three major phenomena that are expected to affect financial analysis and analysts are considered here. Those matters also have considerable influence on the views and conclusions expressed later in the paper. . . . [Also included in 7(b), 16(a), and 18(a)] **[AIMR/FAPC92, p. vi]**

Third, the accounting model used today was developed to fit enterprises whose economic activity was primarily in manufacturing or merchandising. Today, services of all types constitute a major portion of economic endeavors. Financial assets play a larger and larger role as more and more funds are saved and invested than ever before. The current accounting model has been challenged on many fronts. Our conclusion is, however, that it is fundamentally sound but there are many ways in which it could be employed more efficaciously than it is today. Much of the remainder of the paper is devoted to describing our suggestions for improvement. [Also included in 7(b)] **[AIMR/FAPC92, p. vii]**

[Context] Those two paragraphs introduce the following excerpts pertaining to the third major phenomenon listed. Excerpts pertaining to the other two phenomena are included primarily in 18(a)-International harmonization of standards and 16(a)-Databases.

Financial Services and the Proliferation of Financial Instruments

Financial services firms, primarily financial institutions and other intermediaries, are like other service firms in that tangible assets are insignificant to them. But their other assets are different, being composed almost entirely of financial instruments. Most of those instruments represent diverse contractual arrangements with heterogeneous counterparties, with equity investments constituting the remainder. Financial firms also have substantial liabilities in the form of financial instruments. The success or failure of such a firm is to a large extent dependent of how well its management matches, from one side of the balance sheet to the other, maturities, yields, and other characteristics of its financial asset and liability positions. None of this is new. **[AIMR/FAPC92, p. 18]**

What is new are two related matters of current and continuing concern. First is the proliferation of new and exotic financial instruments, many of which do not now appear on balance sheets or, if they do, understate the potential for loss that they engender. Analysts also are confounded by the interrelationships and complexity of financial instruments. For example, how can risks be assessed intelligently for a financial institution that is extensively arbitraged against multiple other financial institutions worldwide? Those risks are at least to be disclosed under the provisions of FASB Statement 105, but the disclosures are scattered throughout the financial statement notes and are understandable only to relatively sophisticated and tenacious financial statement readers. **[AIMR/FAPC92, p. 18]**

Complex and sophisticated financial instruments are used for a variety of purposes and their propagation continues unabated. Some divide single instruments into component parts to serve the specialized needs of certain providers of capital who otherwise could not invest in a particular activity. Others bundle multiple instruments into a single package, again to serve specific investor demands. Many have been designed to shift risks to those willing to undertake them and provide hedging to their counterparties. Others have been designed and are used for more nefarious reasons, such as skirting the boundaries of accounting standards, rules and practices. As additional standards are written, new instruments seem to be created to evade them. At least that is the perception of many financial analysts. **[AIMR/FAPC92, p. 18]**

We commend the FASB for undertaking its gargantuan financial instruments project. In many of its facets we are being forced to face up to the deficiencies arising from application of historic cost accounting to financial instruments. In the worst cases, historic cost accounting has allowed financial enterprises to manipulate reported income by recognizing gains (and less frequently, losses) when they wish rather than when they occurred. Cognate to that is the resultant inclusion on balance sheets of historic costs that bear no relationship to their current value and that too many times conceal the fact that the financial instruments they purport to portray are "under water." **[AIMR/FAPC92, p. 18-19]**

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 4] **[AIMR/FAPC92, p. 19]**

[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 and also at the end of the meeting in response to a direct question, some participants commented on problems raised by financial instruments and off-balance-sheet financing.

Participant I-12
With the environment of the last 20 years, there has been a lot of off-balance-sheet financing. We have evolved and we now have ways to hedge against all kinds of balance sheet and income statement risks. What companies are trying to do is to take the volatility of prices out of their basic business so they can focus on their business. Another segment of our economy, the financial companies, are taking care of the volatility; you have a whole business (swaps, derivatives) that is highly misunderstood by investors where there is virtually no meaningful disclosures. From our viewpoint looking in at [names deleted], it is sort of like a black box. Anybody who gets into that business is going to get a discount because we don't understand it. **[TI 10/16, p. 43]**

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 1(b)] **[TI 10/16, p. 56-57]**

Participant I-12
And I would add financial instruments to the list. [Also included in 1(b)] **[TI 10/16, p. 57]**

Committee/Staff/Observer
The FASB is currently dealing with the subject of hedging and it's a complex area. Is your interest in whether a company hedges or not for economic reasons or are you more concerned about what kind of accounting they're doing through hedging? **[TI 10/16, p. 60]**

Participant I-2
We're more concerned with understanding what they have done. We're not so concerned about their accounting for it. We'd like to understand the ability of the company to make money and the revenue stream they are going to have. We're interested to know what things are going to look like versus what they would have been if there were no hedging, and understand how the hedging has changed the cash flow stream. **[TI 10/16, p. 61]**

Participant I-3
Obviously, it is something we should be asking. Companies usually tell us it's competitive information. Then you learn that they are 75% hedged and you happen to think that the price of the commodity is going up and they're hedged at today's price; it may look a lot less attractive as a company versus a company that is less hedged. **[TI 10/16, p. 61]**

Participant I-6
The accounting aspects are very important too because some of the companies will run that incremental revenue through normal revenue when in fact it is related to a loan that is financing the project. **[TI 10/16, p. 61]**

[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, comments were made on the risks associated with financial instruments and off-balance-sheet transactions.

Participant I-12
Where does the notion of steps the company has taken to mitigate risks come up? I'm thinking particularly about swaps and derivatives. [Also included in 10(a)] **[TI 1/13, p. 44]**

Participant I-12
The big problem I have with current disclosure on derivatives is that it is highly misleading, that is, to disclose notional amounts in a business where the principal is truly not at risk. For most derivatives, it's not a principal risk business; cash flows are being exchanged and it's more of an interest rate risk business (at least for swaps). The current disclosure overstates the risks in some contracts and understates the risks in other contracts. It's very difficult to understand what the huge lump sum number being disclosed mean. What are the real risks and opportunities? [Also included in 10(b)] **[TI 1/13, p. 50]**

Committee/Staff/Observer
One of the reasons for the problems with the disclosure is that we don't have agreement on what the right accounting should be. Until we get that, it's a little hard to address these risks. [Also included in 19] **[TI 1/13, p. 50]**

Committee/Staff/Observer
Is it possible, [participant I-12], that some kind of a sensitivity analysis, or a stress test, on those instruments would be more meaningful in terms of how they move in relation to interest rate changes and how they are related to the instruments they're linked to? [Also included in 10(b) and 10(c)] **[TI 1/13, p. 51]**

Participant I-12
I think that something along those lines could be very useful. There are people who are using those instruments who I suspect haven't the foggiest notion of what they've got. There is a lot of work that needs to be done. [Also included in 10(b) and 10(c)] **[TI 1/13, p. 51]**

Participant I-11
[Participant I-12], isn't part of the problem on that issue the fact that even the participants don't understand the risks? We've seen a number of cases in the past few years where some risk-reducing derivative transaction proved not to work, like portfolio insurance. From my perspective, I think the understanding of the nature of the risks in that whole business is very poor. [Also included in 10(b)] **[TI 1/13, p. 51]**

Participant I-12
I think there is a dealer community that really does understand what they're doing. And there are some unscrupulous people who are selling these things to companies who don't know what they're doing. Maybe by having an accounting that makes better sense, it would point out to them that they're getting into something they don't understand. [Also included in 10(b)] **[TI 1/13, p. 51]**

Participant I-5
The dealer community may know the risks for derivatives that have been around for 5 years, but every year there is something new that comes out and they may not know so well what the risks are. [Also included in 10(b)] **[TI 1/13, p. 51]**

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 5(a)] **[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 5(a)] **[TI 1/13, p. 52]**

Participant I-14
When you get into the big international pharmaceutical or consumer goods companies, especially in a year where there has been a huge currency change, I question whether hedging will do everything. I think that's going to be a very big issue. I don't know how many companies will be very clear about the effects of currency fluctuations on their results. [Also included in 10(b)] **[TI 1/13, p. 52]**

Participant I-12
It's not only the big international companies. I was looking recently at a small thrift ($200 million in assets) that had 2 or 3 million dollars in contracts; if the yield curve changed its shape, this company could have real problems or huge gains. [Also included in 10(b)] **[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 auditor involvement. During the discussion, a comment was made on financial instruments.

Participant I-12
Both. I cover financial companies. There are lots of financial control systems, for example the hedging system, asset and liability management systems; these are critical systems for these companies to run their businesses. It's very difficult for an analyst to know what they're doing; are they controlling the business, do they have open positions or are they speculating? From the existing information we have, we don't know. Some assessment of those control systems, the amount of latitude that it leaves management to engage in speculation in financial markets, would be useful. Maybe I'm asking too much but this is the heart and soul of the businesses that I cover. It's very difficult from the outside to make any assessment of it. Auditors would run across those systems a great deal during the course of their work and they could give us some input. Any business that does hedging nowadays has to have some financial control systems to keep order. [Also included in 17(c)] **[TI 3/17, p. 14]**

[Context] Meeting of the Creditors 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 financial instruments and off-balance-sheet financing.

Participant C-9
Another issue I would be interested in getting more information to work with is the off balance sheet information regarding swaps, derivatives, futures, etc. I think [name deleted] has set a standard of disclosure for others to strive toward, but I think there is a lot more that could be reported, and we're talking very significant dollar flows. I mean you look at [names deleted], we're talking trillions of dollars that aren't even on the balance sheet, and you have very little information. [Also included in 15] **[TC 12/8, p. 29]**

Participant C-11
I agree totally with you, but what we've got so far from that opinion from the FASB (Statement 105) is just aggregate numbers with no qualitative handles on it at all. Do you have a sense as to how we can better report the risks on the off-balance-sheet items? I don't. **[TC 12/8, p. 29]**

Participant C-9
I think that we might prefer to have information on the actual types of breakdown and the composition of the types of instruments that are being entered into. You could look at maturity ranges, what the offsets are, what the credit underwriting is of the counterparties. That's just for starters. **[TC 12/8, p. 29]**

Participant C-3
What you're saying is exactly right on. I think there is a lot of information in the derivatives business that isn't being reported to the users of financial statements, especially the creditworthiness of the counterparties. That's key. **[TC 12/8, p. 29]**

Participant C-14
What I want to know from a company is if there is 100 basis point movement in interest rates, what's the net cash flow impact? Or if there is a certain percentage change in the Deutschemark to the dollar, what is the cash impact in the foreign exchange hedging position? I want something that's tangible, and then I can sit there as an analyst and say all right, I'm expecting interest rates to be gradually rising, so these people are either not -- it's going to be a net disadvantage or advantage to have the position they have. **[TC 12/8, p. 29-30]**

Participant C-13
It seems to me that one way you can approach this question is to disclose one, two, three, or four major variables, be they interest rates, the Deutschmark, sterling Yen, whatever it happens to be, and then some sense of sensitivity impact of those major variables. **[TC 12/8, p. 30]**

Participant C-9
I'd like to see more information on liquidity (for example, gaping). **[TC 12/8, p. 30]**

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), 2(c), and 9] **[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 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 value information. During the discussion, a comment was made on hedging.

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 5(a)] **[TC 2/2, p. 10-11]**

[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 hedging.

Participant C-5
I would go back to [participant C-14]'s 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 5(b)] **[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 5(b)] **[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 5(b)] **[TC 2/2, p. 21]**

[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 financial instruments and off-balance-sheet financing.

Participant C-11
I think it's good to know that the auditors must be nervous about the fact that somebody might sue them, and use a little bit more diligence than they might otherwise do. So I think the auditors should feel a little nervous. That they'd better really get into the stuff or they might be sued. I think that is helpful. On the internal controls, I do think that there's some difficult areas that I would want to feel comfort about, as to what kind of examination really did take place. And I'm thinking of some of these huge off-balance sheet items, such as the foreign exchange contracts, hedging type things. I think it's an interesting avenue to think about. The standard audit letter does not give any feeling one way or another that the critical areas have been looked at in depth. [Also included in 17(a), 17(c), and 18(b)] **[TC 3/11, p. 4]**

Committee/Staff/Observer
Let me pursue this off balance sheet topic that some of you have raised. There is off balance sheet disclosure now. I'd like to have a better feel in terms of what you view the auditor relationship with that off balance sheet information as it exists now is. Do you see that as either ill-defined, well-defined, or needs redefining? [Also included in 17(b)] **[TC 3/11, p. 5]**

Participant C-11
The off balance sheet disclosure that we now have just recently been getting is not useful to me. It's just a bunch of big numbers and it doesn't get into the qualitative aspects of the risks. But addressing the question you're speaking of, I was not necessarily speaking of off balance sheet items versus on balance sheet items. I was thinking of critical areas where, in the case of financial institutions, a massive number of individual transactions take place, and those can be audited on an on-the-spot basis. What is more critical to me is that the whole process of whatever those transactions are, be analyzed as a process, in terms of whether the right data is captured. For instance, are there really hedging transactions being captured or are there a combination of hedging and speculation? So, it's not the individual transaction I'm thinking of. It's the whole process or business that's being undertaken, and whether the proper information is coming in an aggregate form in the right way. And whether the systems involved do capture things properly. And that could be on and off balance sheet. [Also included in 17(b)] **[TC 3/11, p. 5]**

Participant C-12
I think maybe off balance sheet is a whole separate discussion. What we're getting now is minimal information of substantial exposures. And we're getting no explanation of what's involved in these exposures. What the financial risk is, what the credit risk is, how it breaks down. But I think that's a separate topic altogether. [Also included in 17(b)] **[TC 3/11, p. 6]**

Participant C-5
I would agree that current disclosure doesn't give us a view of what the risks are. I will also confess in regular conversations with peer institutions on the very subject that, as we measure our risk to each other, everyone has a slightly different approach. The basic approach is similar, but the numbers all come out differently based on how we quantify risk. We are all moving increasingly towards some commonality in that area, but the idea that you would give an opinion and say that what's been presented is a fair representation, without allowing me to know the differences and have the raw data to make a determination of my own, is troubling. I know my aggregate positions with any other counterpart but I have no concept of their aggregate exposure. And the raw information which is provided is clearly insufficient to make some determinations or risk calculations. Whether it's something as complicated as options, forwards, and swaps, or something as simple as purchased intangibles, like servicing rights. Just in the last year, the dynamics of that market have been so significant that we have been throwing credits out of our committee because our own people don't even know the detail behind the numbers. And we have difficulty getting them. Management can't provide them. If they can't provide them to us as a negotiating creditor, I doubt the auditors have been able to get that kind of information, or really have reviewed it in the right kind of depth. [Also included in 17(b)] **[TC 3/11, p. 6]**

Participant C-13
There are two issues here. I agree with everything that has been said about disclosure and availability of information for off balance sheet items and liabilities and assets and contingent liabilities. But the other issue is the audit and control issues concerning those items. And I think everything that you've heard in the last three minutes suggests that there's a concern, a serious concern, about the controls that exist. There have been numerous instances of surprises or failure of controls among very large companies. That would suggest that the users are very interested in the audit functions of these off balance sheet items. [Also included in 17(b)] **[TC 3/11, p. 6-7]**

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 2(d) and 17(b)] **[TC 3/11, p. 7]**

[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 financial instruments and off-balance-sheet financing.

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 5(a) and 15] **[TC 3/11, p. 69]**

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 3(d), 11(c), and 15] **[TC 3/11, p. 69]**

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 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), 5(c), and 15] **[TC 3/11, p. 69-70]**

Committee/Staff/Observer
[Participant C-14], do you have the ability to get some of that data from your customers? In other words, does it have to be reported in the GAAP financial statements or can you ask for and receive it? **[TC 3/11, p. 70]**

Participant C-14
The first thing I brought up about maturities and interest rate sensitivity, we can usually get that. The swaps, I don't always have the impression that management has as good a handle on what their sensitivity is to their swaps as I'd like to get. And I don't know if that's because it changes day to day and they can't tell me or if they really, at the level of the people we talk to, don't have a handle on it. **[TC 3/11, p. 70]**

Participant C-15

I'll go with number 11 (core earnings) as my first choice. And 13 (financial instruments) is my second choice. [W]e always ask the questions and we meet with financial institutions and increasingly with industrial companies and so on about their off-balance-sheet financing, in particular swaps and other types of instruments. And I think that we find at the senior management level, CFO level, that we deal with that they broadly understand the issues. But when it comes down to getting into specifics, they say that they have somebody locked away in a corner room someplace who is really doing all this work. Something going forward which I think is going to be increasingly important are these environmental liabilities (number 14). They're kind of difficult to get your hands around but these are the types of things, if you look at a company like [name deleted] for example, that just came out of the clear blue. You looked at their balance sheet and income statement, you didn't have a hint anything was wrong with the company. Well, you knew something was wrong by reading the footnotes that they had these asbestos related liabilities but the next thing they're on their way over to bankruptcy court. I think that disclosure of those types of liabilities going forward is going to be increasingly important. [Also included in 10(b) and 15] **[TC 3/11, p. 70-71]**

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 4, 8(b), and 15] **[TC 3/11, p. 71-72]**

Participant C-11

11 (core earnings), 3 (unconsolidated entities) as it encompasses also annual and interim segment reporting by business, major business segments. And also 13 (financial instruments) but only if you really can get something related to the risk aspects of those matters as opposed to just lots more numbers. And I don't know if that's possible so I really want to put it with that caveat, that more information that is not analytically useful in terms of understanding risk is not helpful. [Also included in 15] **[TC 3/11, p. 73]**

Committee/Staff/Observer

In other words, it's not quantitative, it's qualitative. **[TC 3/11, p. 73]**

Participant C-11
Yes. **[TC 3/11, p. 73]**

Participant C-17
I'm not going to expound on what's already been said about the categories, just add whatever addition or comment that seems appropriate. Number 11, core earnings, is my first choice. And I really felt that number 9 (display) was almost an integral part of that. And then from there, I looked at number 13 (financial instruments) as second in order because I am not convinced that even senior management of the company really truly understands what it's all about. So it's sort of a backdoor way of getting their attention. There are too many instances where they've had surprises that they were totally unaware of because they didn't completely understand. And then 10 (operating opportunities and risks) for the obvious reasons. [Also included in 15] **[TC 3/11, p. 73-74]**

Committee/Staff/Observer
I have a specific question on 13 which is accounting for financial instruments including off balance-sheet-financing. Those who ranked that in the top three, did you include off-balance-sheet leases or weren't you thinking about it? [Also included in 8(c) and 15] **[TC 3/11, p. 74]**

Participant C-11
Not in the same context. For different reasons, I think this classifies as off-balance-sheet. I think they're very different risks. [Also included in 8(c) and 15] **[TC 3/11, p. 74]**

Committee/Staff/Observer
So would you also encompass in 13 changes in accounting or information about off-balance-sheet leases? [Also included in 8(c) and 15] **[TC 3/11, p. 75]**

Participant C-11
I think it should be on balance sheet myself but . . . [Also included in 8(c) and 15] **[TC 3/11, p. 75]**

Committee/Staff/Observer
But the reason is not because of the qualitative questions you had with respect to everything else that's off-balance-sheet? [Also included in 8(c) and 15] **[TC 3/11, p. 75]**

Participant C-17
I don't think anybody's mystified about what an operating lease is all about. I think there's a great deal more esoteric around the hedging situation. I'm not certain that the management itself always has the sophistication or focus that they ought to. [Also included in 8(c) and 15] **[TC 3/11, p. 75]**

[Context] Responses to the postmeeting questionnaire to the March 17, 1993 Investor Discussion Group meeting.

QUESTION 17

At the end of the meeting, some participants mentioned that off-balance-sheet financing was near the top of their list of issues that need urgent attention.

For purposes of the following questions, "off-balance-sheet" refers to assets and/or liabilities that are 1) never reported on the balance sheet, 2) a significant portion of the risks and benefits associated with those items are not reported on the balance sheet, or 3) some previously reported assets and/or liabilities are removed from the balance sheet. Common *examples* of off-balance-sheet financing arrangements include:

- *Securitization and factoring of receivables*--When receivables are sold to a third party but the entity retains some of the risks associated with the receivables by guaranteeing their ultimate collection (recourse provision).

- *In-substance defeasance of debt*--When certain securities are purchased and placed in an irrevocable trust, the sole purpose of the assets being to provide for the timely payment of principal and interest of one of the entity's liabilities.

- *Operating lease arrangements*--When a lease contract does not meet the criteria for recognition under current accounting literature, and, therefore, the lessee does not capitalize the leased asset on the balance sheet.

- *Certain financial instruments* -- When the instruments are not accounted for, or only partially accounted for, on the balance sheet, including: interest rate swaps, forward contracts, guarantees and commitments, etc.

a. Do you find the lack of consistent reporting and disclosure practices for off-balance-sheet instruments and transactions a significant impediment to your investment analysis work?

YES *4*
NO*1*

If YES, why?
Participant I-16: Off-balance-sheet financing understates the assets required to conduct the company's businesses and understates risks by ignoring potential liabilities and/or volatility.
Participant I-9: In retailing in particular, companies try to understand their sale leaseback responsibilities to have better debt equity ratios. In any industry that requires on-going financing for expansion on a routine basis, managements try their best to make their balances appear better than they should be to cover their capital cost.
Participant I-7: Carry risk that can come back to materially affect net.

b. How should problems associated with off-balance-sheet financing be solved? (Choose ONE.)

1. By developing accounting methods that will *record those items* in the financial statements in a consistent manner?	*1*
2. By extending the *quantitative* information that should be *disclosed* about those items in the notes to the financial statements?	*1*
3. By requiring *qualitative* information that should be *disclosed* about those items in the notes to the financial statements?	
4. By a combination of accounting methods and disclosure requirements? Describe: *Participant I-16:* Where off-balance-sheet liabilities are reasonably measurable they should be included on the balance sheet. Other off-balance-sheet items should be described as well as possible, quantitatively and qualitatively.	*2*

Any comments on the approach you selected above?
Participant I-9: All leases of retailers that are not annually (1 year) reviewed should be treated the same way.
Participant I-11: I think most of these issues usually arise with financial institutions. I don't do any work in this area, and don't feel competent to speak on the issue.

[PMQI 3/17, p. 30-32]

[Context] Responses to the postmeeting questionnaire of the March 11, 1993 Creditor Discussion Group meeting.

QUESTION 17

At the end of the meeting, several participants mentioned that off-balance-sheet financing was near the top of their lists of issues that need urgent attention.

For purposes of the following questions, "off-balance-sheet" refers to assets and/or liabilities that are 1) never reported on the balance sheet, 2) a significant portion of the risks and benefits associated with these items are not reported on the balance sheet, or 3) some previously reported assets and/or liabilities are removed from the balance sheet. Common *examples* of off-balance-sheet financing arrangements include:

- *Securitization and factoring of receivables*--When receivables are sold to a third party but the entity retains some of the risks associated with the receivables by guaranteeing their ultimate collection (recourse provision).

- *In-substance defeasance of debt*--When certain securities are purchased and placed in an irrevocable trust, the sole purpose of the assets being to provide for the timely payment of principal and interest of one of the entity's liabilities.

- *Operating lease arrangements*--When a lease contract does not meet the criteria for recognition under current accounting literature, and, therefore, the lessee does not capitalize the leased asset on the balance sheet.

- *Certain financial instruments* -- When the instruments are not accounted for, or only partially accounted for, on the balance sheet, including: interest rate swaps, forward contracts, guarantees and commitments, etc.

a. Do you find the lack of consistent reporting and disclosure practices for off-balance-sheet instruments and transactions a significant impediment to your credit analysis work?

__10__ YES __3__ NO

If YES, why?

Participant C-8: This is where getting additional disclosure from management is different and the information is often not complete. Full disclosure in the financial statement will allow creditors to better assess the risk.

Participant C-15: Derivatives not fully disclosed. Could represent substantial risk.

Participant C-13: I would describe it more as a significant inconvenience than impediment. The lack of consistency, in some cases, makes adjustments for comparability difficult. In other cases, (financial instruments), lack of disclosure that is adequate leaves the credit analyst in the dark.

Participant C-14: So little information is provided that no real emphasis can be done; we have to know what is at risk.

Participant C-12: Many banks now report more credit risk exposure from foreign exchange and swaps than from lending. However, whereas loan portfolio detail includes 5-10 pages of detail, only the gross exposure number is given for foreign exchange and swaps.

Participant C-11: 1) Securitization - footnote should disclose when credits securitized with come back to the company unless resecuritized. 2) Leases - should be recorded on the statement as debt. 3) Past losses on swaps and guarantees should be recorded like loan losses.

Participant C-21: Because these items can have a detrimental effect on the company's ability to service bank debt. And you do not have third party verification if not disclosed in footnotes.

Participant C-17: Tough to indicate consistency from year to year.

Participant C-9: Given the limited, static footnote information it is difficult to assess the ongoing risk profile (market and credit) to compare or contrast with management's presentation of strategy and practice.

b. How should problems associated with off-balance-sheet financing be solved? (Choose ONE)

__0__ 1. By developing accounting methods that will *record these items* in the financial statements?

__7__ 2. By extending the *quantitative* information that should be *disclosed* about those items in the notes to the financial statements?

Participant C-14: Definitely.

__5__ 3. By requiring *qualitative* information that should be *disclosed* about those items in the notes to the financial statements?

__4__ 4. By a combination of accounting methods and disclosure requirements?

Participant C-14: Maybe.

Participant C-11: See 17a.

Describe:

Participant C-13: Average in accounting methods in some cases (leases); expanded quantitative disclosure in others.

Note: Some participants marked more than one item.

Any comments on the approach you selected above?

Participant C-14: Measure risk for disclosure in terms of cash flow sensitivity of net positions in hedging securities accompanied by management discussion of why the net position exists and how it may be offset.

Participant C-12: Once the credit risk on financial statements ("off" balance sheet or "on") reaches some size relative to loans, e.g., 20%, then the detail provided on financial instruments should approximate that provided for loans.

Participant C-9: Netting, average outstandings, high-lo, volatility, by type of contracts, by counterparties, margin calls, renegotiated.
[PMQC 3/11, p. 27-30]

III Content Analysis of Sell-Side Financial Analysts' Reports

III Content Analysis of Sell-Side Financial Analysts' Reports

Financial Analysts' Use of Business Information

A *Working Summary of Findings*[1]

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[1] Articles based on this research have been published or are forthcoming (to date) in *Accounting Horizons* and the *Journal of Accounting, Auditing, and Finance*.

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INTRODUCTION

Since enactment of the federal securities legislation in the 1930s, financial reporting in the United States has evolved in a regulated environment to provide greater and broader company information to sophisticated and unsophisticated equity investors and other stakeholders. While such parties obtain information from a variety of sources, traditional financial reporting provides analysts and other users with a significant part of the information platform for forecasting companies' future performance. This implies an importance for sound accounting and financial reporting policies, particularly when it is not well-established that there are sufficient market mechanisms or incentives for management to voluntarily disclose "proprietary" information to users. Such policies can increase social welfare by improving investor resource-allocation decisions, and reducing duplicative information production costs by information intermediaries.

In 1991, concerns about financial reporting led to the formation of the American Institute of Certified Public Accountants (AICPA) Special Committee on Financial Reporting. The committee's activities included sponsorship of research to explore, categorize, and quantify the types of information found in equity analysts' reports, through its Users' Needs Subcommittee [AICPA, 1992]. This paper summarizes the results of one such study, which assessed sell-side financial analyst information use, by applying content analysis to a sample of full-text sell-side analyst company reports. Sell-side financial analysts are an important category of information intermediaries. Studying their use of company information is one way of assessing the adequacy of accounting and financial reporting policy.

Our findings have been considered by the Special Committee in the formulation of a preliminary set of recommendations [AICPA, 1993]. Discussions of the Special Committee's preliminary recommendations have appeared in the *Wall Street Journal* [1993(a)(b)], the Financial Executives Institute's *Briefings* [FEI, 1993] and *Financial Executive* [FEI, 1994], *Management Accounting* [Barlas, 1993], and elsewhere.

PRIOR RESEARCH ON USER INFORMATION NEEDS

A traditional concern about accounting and financial reporting policy is that accounting reports do not fully address the information needs of investors and other corporate stakeholders [Lee and Tweedie 1977, 1981, 1990, Rimerman, 1990][1]. Since the 1970s, a variety of studies of the usefulness of traditional reporting practices to the investment community have been undertaken, as reviewed by Chang and Most [1985] and Hawkins and Hawkins [1986]. Schipper [1991] summarizes research on analysts' forecasts and notes that "it makes sense to study analyst decision processes because analysts are among the primary users of financial accounting information." Similarly, Zmijewski [1993] queried "What information do financial analysts use in selecting stocks?"

While Lang and Lundholm [1993] examined Financial Analyst Federation reports to assess analyst evaluation of the adequacy of company disclosure, a more common method of studying analyst's use of financial reports and other information has been to survey them. Some studies, such as the Financial Executives Research Foundation's (FERF) [SRI, 1987, p. 34], have selected large samples of analysts and used general survey instruments, while other studies (such as Lee and Tweedie [1977, 1981]), have conducted more detailed interviews of smaller samples of investment professionals.

These studies frequently analyze the use and importance of particular types and sources of information. Hill and Knowlton [1984], for instance, reported that financial reports were ranked second in importance only to direct discussions with management. The FERF study reported that the five "most-used" sources of information were, in descending order: (1) the company annual report; (2) SEC Form 10-K; (3) the company quarterly report; (4) other analysts or professionals; and (5) company management. Professionals ranked company management as the "most important" <u>source</u> of information [p. 38]. The annual report, which ranked first in frequency of use, ranked fifth in importance as a source of information. The five types of information reported to be of most interest to analysts were recent developments and outlook for the company's industry, annual company earnings, company's position in the marketplace, risks to which the company is exposed, and recent events affecting the company [p. 31].

Some of these studies survey analysts about improvements to financial reports. Several have found professional investor agreement that financial reports needed to better present management goals and strategies and the competitive position of its operating units. The FERF study, for instance, related analysts' opinions that financial reports could be improved by providing information on the company's market and competitive position, business segment financial statements, intra-industry comparisons, management goals and objectives, and company performance statistics and ratios. The Hill and Knowlton study included recommendations by investment professionals to:

(1) "present the business in a segment-by-segment format" and

(2) "Disclose as many details and numbers as possible".

Evident among the findings and recommendations of these studies is the desire of analysts for information with greater detail, not surprising given that: (1) analysts make earnings per share (EPS) forecasts by first disaggregating a company into its operating units, and (2) analysts do not bear the cost of preparing disaggregated reports. This preference is corroborated by the recent study sponsored by the Canadian Institute of Chartered Accountants, which stated "Sell-side analysts ... placed higher than average importance on...more detailed segment reporting..." [Boersema and Van Weelden, 1992].

In other areas, many surveys have found only a limited desire for added information by investors and investment professionals. There is little reported demand, for instance, to restate balance sheet or income statement values to market. McCaslin and Stanga [1986] note that analysts assigned more importance to such items presented at historical cost than in constant dollars or current costs.

These and other studies provide evidence about the capacity of traditional forms and practices of reporting to meet the demands of the contemporary investment community. Implicit in some is the belief that there must be a "fresh start" or "new model" [Elliott, 1992], while others seek more evolutionary and supplemental approaches to "re-engineer" traditional reporting. In either case, they confirm an importance to better understanding the needs of constituencies which comprise the generic term "investor" (and other financial report users).

DATA AND METHOD

To assess analyst information use, we departed from the technical approach to using financial analyst-based databases, as described by Philbrick and Ricks [1991] or as used in Lang and Lundholm [1993], or surveys as described above, and employed content analysis [Weber, 1990]. Content analysis has been previously applied to financial analysts' reports by Govindarajan [1980], who conducted a limited content analysis of 976 analyst reports[2], and in other accounting research [Tinker and Neimark, 1987, Warnock, 1992]. While content analysis data does not lend itself to statistical analysis, its use as a method is eminently suited for applications in which the data are textual in nature, rich in substance, and strongly context specific[3].

Our data were a sample of full-text sell-side financial analyst company reports. Analyst reports are commonly structured to include basic information about a company and the analyst's evaluation of that information. However, analysts also report assessing a larger set of information than that included in their reports, as observed by Schipper [1991][4].

We obtained sell-side analyst company report data from a commercial database, Investext. Investext describes itself as containing "over 320,000 full-text company and industry research reports authored by analysts at more than 270 of the world's leading investment banks, brokerage firms, and consulting companies."

We initially sampled 327 New York Stock Exchange (NYSE), American Stock Exchange (ASE), Over-the-Counter (OTC) and "Small Cap" companies. These companies were randomly selected from Compustat, except for the "Small Cap" companies, which were randomly selected from the Wall Street Journal's Small Cap listing. Our sample, described in Table 1, was stratified on exchange - NYSE, ASE, OTC, WSJ Small Capitalization, two digit SIC code (i.e., industry), and company size (revenue).

We studied three recent one-year periods in order to better capture differences in information use that might accompany differing business conditions. The first period, July 1, 1987 to June 30, 1988, covered the year prior-to and surrounding the 1987 stock market crash. The second period, January 1, 1990 to December 31, 1990, covered the period during which the U.S. entered a recession. The third period, July 1, 1991 to June 30, 1992, covered the year of a modest economic recovery and bull market.

Using the Investext database, we selected one analyst report for each company in each of the three time periods, per Panel B of Table 2. The brokerage firm was varied in order to representatively include the fourteen largest brokers [Institutional Investor, 1992, 1991, 1990] as well as smaller brokers,[5] as listed in Table 2, Panel A. There were no analyst reports for 113 companies. The remaining 214 companies had reports in one, two, or all three time periods under study. In total, our final sample consisted of 479 individual full text reports for the 214 companies, totaling about 3,500 pages of single-spaced text, tables, schedules, and reproduced financial statements, as given in Table 1.

The analysis of our sample was preceded by a pilot phase. In the pilot phase, a set of ten company reports was selected. Word and phrase frequencies were determined using content analysis software[6]. The reports were also read by each of the four authors. Then, again using content analysis software, we evaluated the context and use of frequently occurring words and phrases in the reports. From this analysis, a standardized coding instrument was developed, which described the reports in terms of qualitative and quantitative information. Following completion of the coding instrument, each of the four team members reviewed a common set of reports and the completed coding forms. These forms were then reviewed by the team to assist in consistent coding.

The data set was analyzed in two ways. First, the 479 reports were divided among the team members. Each report was read in full, and a coding form was completed. Second, the full data sample was indexed and analyzed using the content analysis software.

The printed reports, completed coding forms, and electronic database formed the basis for further, iterative analysis. Our general procedure was as follows:

(1) Research team meetings to review coding forms, discuss (2) and (3) below, evaluate word phrases, and assess results to date,
(2) Analysis of previously selected word phrases and themes and their contextual characteristics, related to (3)
(3) Identification and preliminary analysis of new word phrases and themes related to previously selected word phrases using coding forms, analyst reports, and the database.

The referencing feature of the content analysis software was used to compare reports in the electronic database on common features. For example, the software facilitated simultaneous in-context study of "cash flow per share" across all the reports. We also computed word, phrase, and word-grouping frequencies in order to guide our analysis of report features, and examined the word and phrase occurrence within the context of their full report.

ASSESSMENT OF ANALYST REPORTS

Income Statement Related Findings

• ***Overview***

We found that income statement and performance-related discussions dominated analysts' reports. This is consistent with prior findings and supports the fundamental link between earnings and security prices demonstrated in a long line of "valuation studies", most recently by Lev and Thiagarajan [1993], and as argued by Easton [1985], and others. Income statement related terms or phrases appear nearly 60,000 times, on average over 123 times per report, far more frequently than combined references to balance sheet and cash flow terms, circa 19,000 times overall or 34 times per report. About 70 percent of the reports contain annual income statements, and about 40 percent contain both annual and quarterly income statements[7]. Earnings, earnings-per-share (EPS), profit[ability], revenue[s] and income are the most frequent income statement terms. Earnings-based ratios, such as price-to-earnings (circa 1,700 occurrences) are common. Analysts also consider information that is predictive of future earnings, such as order, backorder, and shipment data, not reflected in the most recent income statement.

Revenue change is discussed, particularly as a result of product pricing, volume, and demand, and product mix. Production and sales volume information is analyzed. Expenses are only analyzed at a general level. "Expenses" occurs about 8.4 times per report, and "margins" occurs about 8.7 times per report. Less frequently used phrases are "operating costs" and "SG&A expenses." Relative cost levels are compared across companies, and management efforts to reduce costs are evaluated. More detailed observance of noncapital expenditures occurs on research and development expenditures, depreciation, materials and labor. "Tax rate[s]" occur 2.9 times per report and are most commonly discussed when rates change significantly across periods.

- ***Segment Reporting***

Analysts often estimate future EPS by disaggregating the company into its constituent operating units and/or geographic regions, developing forecasts of the performance of individual units, and reaggregating segment forecasts to form a company EPS estimate.[8] On average, segment related phrases appeared 47.6 times per report. 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".

Analysts often disaggregate company performance into a finer set of operating units (segments) than specified by GAAP. For example, one analyst commented that a company "reports two lines, but there are actually three." Analysts regularly discuss the above matters with respect to each operating unit; one waste removal company was analyzed by individual landfills and a gaming company by individual casinos. In the same way, operating revenues and expenses are often assessed 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. Similarly, consumer goods manufacturers are often evaluated in terms of individual product lines or products. Some analysts consider the effect on the entire company, industry and economy, as well as revenues and costs in forecasting the results for each reporting unit.

• ***Core Earnings and Earnings Quality***

Our assessment of company core earnings and earnings quality included analysis of occurrences of words and phrases related to core earnings, including "base earnings" and "adjusted earnings" and earnings predictability related phrases. The resulting report sections were extracted and analyzed for discussions that explicitly or implicitly related core earnings with earnings predictability. Finally, we searched the database for earnings quality related phrases, including related income-statement type phrases (such as EPS or revenues) and "quality" synonyms such "credibility", and words and phrases related to the choice of particular accounting methods. We extracted all sections of reports that contained discussions relevant to earnings quality and analyzed the content of each report in terms of earnings quality definitions generally.

The search phrases referencing core earnings and earnings predictability are listed in Table 3, Panel A. When analysts define core earnings, they exclude nonrecurring items included in operating income. One report defined core earnings as "pre-tax income minus the gain on sale of assets and any non-recurring expenses or income, with the provision for loan and real estate losses adjusted to equal the average trailing four-quarters provision for losses." Although predictability is not explicitly mentioned in the above instance, the implication of extrapolation from past, recurring items is evident.

Discussions of revenue/earnings "streams" also illustrate analysts' interest in recurring earnings. Examples include the following comments of analysts:

- "[the company] has a blockbuster in its current release ... which will provide a revenue stream for years to come..."

- "Film distribution provides a less volatile revenue stream than film production..."
- "Clearly, in choosing between the two stocks, investors would pay less for the one with the more uncertain earnings stream"
- "...military projects ... are providing a consistent revenue stream."
- "[This operation] provides a strong, more predictable revenue stream."

It is also common for analysts to compute operating earnings per share or adjusted earnings per share. These computations typically involve the removal of items from continuing operations that analysts judge are nonrecurring, as well as normalization of certain losses and expenses. Analysts often link core earnings and earnings predictability in discussions of companies' "operating earnings" (which are not necessarily equivalent to "operating income"), and operating revenue.

Finally, analysts' attention to core earnings is evidenced by their treatment of "restructuring charges" reported by companies. Restructurings are often catch-alls for a variety of charges taken by companies and usually reported as a separate item. Restructuring charges include long-lived tangible asset write-downs or retirements, inventory write-downs, goodwill and other intangible asset write-downs, legal expense accruals, workforce reduction costs, bad debt adjustments, and costs associated with the disposition of business units. Analysts typically treat these charges as one-time occurrences. One analyst wrote, for instance: "Reversing the [restructuring charge], domestic operating profits rose 22.6%", while another stated "Net of the restructuring charge ... [the company] lost $.13 per share from continuing operations". This is further evidence of the interest of analysts in identifying the core operating results of companies.

The extracted report sections generally confirm that analysts value economic earnings predictability highly and associate earnings predictability with earnings quality. One report, commenting on the market discount of a particular company's stock, stated: "Given our expectations for ... reduced earnings volatility .. we do not believe this discount will persist." Other reports stated that: "the utility segment has dramatically broadened its customer base and, in turn, significantly reduced revenue and earnings volatility", and "because of the company's historically erratic earnings record... [the market discount of the stock should] narrow as revenue and earnings visibility continue to improve and volatility declines." Yet the preference for high earnings predictability is not universal, as evidenced by the following analyst's comment: "[Earnings] unpredictability in theory should penalize the company's multiple. In practice, there will be times when the multiple is penalized and times when it is rewarded, because the possibility of a runaway hit and break-out earnings will lead to speculation."

Earnings predictability tends to be associated with core earnings type phrases (Table 3, Panel A). Instances of terms associated with core earnings, include the following:

- "the fourth quarter of 1989 was the inflection point for core earnings",
- "core earnings [at these companies] will likely continue to be masked by high commercial real estate credit costs",
- "[even after] nonrecurring items ... adjusted earnings were a very disappointing $0.30 per share."

The terms "inflection point", "continue", and "nonrecurring" suggest that core earnings provide the basis for the formation of expectations about future performance (earnings predictions).

There is also evidence of a relationship between recurring, consistent, and predictable earnings, and earnings quality. As shown in Panels A and B of Table 3, there were numerous references to both[9], including occasional explicit comments linking the two. For instance, in terms of revenue types, franchise fee revenue is associated with low earnings quality, while items such as royalty fees and sales of supplies and equipment (for a franchiser) are associated with high earnings quality. One report commented: "Over this time frame the quality and predictability of earnings should improve as the proportion of revenue contributed by franchise fees declines...", and "we expect the percentage of revenues contributed by recurring royalties to increase from 27% today to over 40%, thereby improving the quality and predictability of the company's earnings stream." More generally, another report stated: "The 'quality' of the earnings advance was excellent, that is, strong pretax income growth (up 42%) and operating income growth (up 28%)...". Earlier references relating higher earnings predictability to higher stock valuations are additional evidence of a relationship between the economic form of earnings quality and earnings predictability.

Search phrases and frequencies related to accounting earnings quality are included in Panel B of Table 3. In the report sections extracted, we found limited evidence that conservative accounting methods are a signal of high quality earnings, per se. For example, one report contained the following heading: "Quality of Earnings is High Because of Conservative Accounting". Similarly, one report raised questions about revenue quality because of the adoption of a new, less conservative revenue recognition method. On the cost side, there was some evidence that conservative depreciation (accelerated methods over short lives) was equated with high quality earnings. One report stated that the "Quality of earnings appears excellent, with depreciation at about 13% of gross property and equipment."[10] Other reports associated low earnings quality with the propensity of a company to capitalize costs of the sort expensed by other firms: "[The company] has been extremely aggressive in the amount of software it has capitalized", and vice versa. The capitalization evidence is difficult to interpret, since management may exercise discretion from year to year in such capitalizations.

We examined analysts references to inventory costing methods for an association between conservative accounting methods and high earnings quality. In terms of inventory valuation, we explored whether LIFO, as a more "conservative" accounting method, was associated with higher quality earnings. The terms "LIFO" and "FIFO" were used 115 times and 64 times, respectively. We found no relationship between earnings quality and inventory costing method per se. Rather, discussions of earnings quality related to inventory costing almost always involved companies' quarterly LIFO reserve adjustment. For example one report stated that "...earnings quality could have been better. As expected a positive LIFO inventory adjustment gave final-period profits a slight boost." That this is, at least in part, a discretionary adjustment is suggested by the report which stated that "We view ... the most likely source of a positive earnings surprise as the fourth quarter LIFO adjustment [because the company] tends to be conservative in these estimates during the year...".

There were many more report passages linking discretionary conservative accounting accruals with earnings quality. One report stated that "The results are very high quality ... [the company's] reported earnings are not only good on the surface, they understate what was a phenomenal quarter from operations." The report recommended purchase of stock in the company, in part, because of the company's "high quality of earnings". Or more transparently, one report stated that "In our view, [the company's] reported earnings are of much higher quality than for most companies. ... With all its businesses booming, the opportunity to 'manage down' earnings exists." As examples, the report cited a high book tax rate and inclusion of nonrecurring expenses in operating results (charges for relocating headquarters included in operating expenses).

A company's book tax rate was frequently associated with earnings quality, such that higher rates were associated with larger discretionary reserves and higher earnings quality. Analysts' discussions suggest their view of management's discretion over this item. One report stated that "...earnings quality is low because of favorable tax treatment". Other reports stated that a company's tax accrual rate decline "caused some to question the quality of earnings at [the company] ... and caused a sharp drop in the stock price", and (in another report) that earnings quality were low because of "a big drop in the tax rate." Another company's earnings were described as "clean" because "although there was a $10 million LIFO profit, this was more than offset by a $10 million charge to reduce employment ... and a $10-12 million inventory writeoff. Finally, the tax rate was 30.8% compared with 6.5% a year ago."

There was also evidence of an association between management discretion and bad debt accruals. The discretionary ability to manage bad debt accruals is suggested by the following passage: "... the company is reserving conservatively for any expected losses. The reserve for doubtful accounts is .. more than 4.5 times what the company wrote off in 1991." Another report stated that "Excluding the costs associated with bad debt reserves ... we estimate [the company's] SG&A expense rate in Q1 was virtually flat" implying a belief in a degree of management discretion over bad debts, although not linking this to earnings quality. The discretionary accrual of bad debts during good times to create a reserve for future earnings-increasing accruals is suggested by the following passage:

> • "Included in the SG&A figure is a series of one-time charges [the company] took in order to offset the one-time gain reported from [an overseas IPO]. The charges ... [include] $17.6 million for planned closure of underperforming restaurants, and $12 million in writeoff for potentially uncollectible account receivables. ... we view [the receivable charge] as one of conservative accounting..."

Overall, there were less than fifty bad-debt related words and phrases. Earnings quality was not discussed, either as related to management discretion or conservatism.

Other discretionary accruals, allowances, OBSAs *were* associated with earnings quality. One report questioned the quality of a company's reported earnings as follows: "Quarterly earnings received a boost of $10.5 million from gains on the sale of securities, which we find puzzling since the investment portfolio had $250-million in unrealized losses... Furthermore, management opted to reduce the loan-loss reserve ... which we find equally perplexing." Another commented: "[The company's] method for gains on sale of loans, and conservatively present-valuing excess future value of servicing against assumed cost of servicing, has generated off-balance sheet assets (potential profit) ...". One report, ostensibly addressing economic earnings quality, in fact addressed accounting earnings quality as follows: "... more aggressive recognition of problem assets could lead to reduced earnings volatility and thus a reduction in the returns required by equity investors." Among the most telling comments was the following: "EPS were $0.57 compared with ... our estimate of $0.57. The company managed to make the numbers despite lower revenues and weaker margins due to higher than expected other income and a lower tax rate...". The analysts' use of the phrases "opted" and "make", and "puzzling" and "perplexing" imply not only the use of discretionary reserves to manage earnings, but a value judgment by the analysts on the quality of the reported earnings.

Finally, although restructuring charges were viewed as one-time occurrences, they were not associated with either earnings quality or management discretion, per se. However, some components of restructuring charges were so interpreted, for example the establishment of specific reserves and allowances, as discussed above.

• ***Earnings Momentum***

Analysts exhibit interest in earnings momentum, or "earnings power," which is generally defined in terms of *earnings growth trends*. One report, for example, commented on a firm's "strong accelerating growth." This differs from the earnings growth rate reported, which is linear, and suggests a nonlinear growth component. The idea of earnings momentum resembles Ijiri's notions as found in his triple-entry bookkeeping treatise [Ijiri, 1986]. That is, earnings momentum reflects a belief that a company's earnings growth can be curvilinear (either upwards or downwards). Analysts also frequently note potential *earnings surprises*. One report stated that "[the company's new product] is a potential source of upside earnings surprises" and another stated that "[the company's] high operating leverage can provide upside earnings surprises..."

Balance Sheet Related Findings

Balance sheet references occur 34.1 times per report, including references to cash. The most common references (excluding cash, discussed later) are to "asset[s]", "capital[ization]", "debt", and "equity", these phrases each occurring on average five to six times per report. Balance sheets are presented far less frequently than income statements, and often only in summary form.

Company balance sheets are usually evaluated on a cost basis. Exceptions are: (1) companies with significant off-balance-sheet assets, (2) thinly traded companies, (3) "poorly understood" companies, (4) industries with "asset quality" problems (e.g. banking) and (5) takeover targets. Long-term productive asset values on the balance sheet are commonly evaluated at cost. The effect of inflation on such assets is rarely explicitly considered. However, as noted above, a supplemental analysis of assets' market value may be conducted for companies that analysts consider to be poorly understood by other analysts and investors, particularly where latent significant off-balance-sheet or hidden assets may exist, or where asset quality is an issue. For example, analysts 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 observed 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.

Liabilities are usually addressed in a summary fashion, often in a simple analysis of the capitalization of the corporation. Extensive attention to liabilities usually occurs only for companies that are highly leveraged and typically in conjunction with a cash flow analysis. However, analysts identify company risks and concerns, which appear 2.1 times per report, and which are broader and less quantifiable potential future reductions of stockholders' equity than are liabilities, obligations, or contingencies. 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; however in one instance a change in auditors was listed as a "risk" factor".

Cash Flow Related Findings

Cash flow analysis 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. Yet other reports make no mention of cash flow at all. On average, cash flow phrases occur about 7.5 times per report. Over one-quarter of the reports contained cash flow statements.

Many analysts produce Non-GAAP cash flow schedules, including discretionary or free cash flow. Among the nontraditional cash flow formats were the following:

1. Net income
   +/- all effects except cash interest
   = cash flow available to common
   - cash interest
   = net cash flow

2. Direct operating cash flows
   - priority outflows
   - discretionary outflows
   + financial inflows
   = change in cash

Although cash flow per share calculations are not permitted in filings under SEC rules nor by SFAS 95, cash flow per share or operating cash flow per share are presented in almost one-third of the reports. Other per share calculations include "fully diluted cash flow per share","distributable cash flow per share", "excess cash flow per share", "discretionary cash flow per share", or "free cash flow per share".

Some 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 flow".

Cash flows appear to be more important to 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 reduction is likely. One report stated 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".

Other Financial Statement Related Findings

• ***Common Size Reports***

Financial statements are not infrequently converted to common size reports; elements of the balance sheet or income statement for comparative periods as a proportion or percent terms of a key number of the statement, such as total assets or net revenues. About one-quarter of all reports containing an income statement also contained a common size income statement.

This proportion is much larger when including the many income statements that contain selected common size information.

• ***Company Valuation***

We found that 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 these approaches analysts also distinguish between a company's "public market value" and "private market value". One analyst valued companies in terms of revenue, cash flow multiples, and net income. Another valued a cable TV company with purported off-balance-sheet assets on three bases:

1) present value of cash flows,
2) appraised value of assets, and
3) the company's liquidation value.

A different 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. Analysts label valuations of a company based upon its acquisition or breakup as its "buyout value," "breakup value," "takeover value" or "theoretical breakup value."

<u>Nonfinancial Information Findings</u>

In this study, we found substantial nonfinancial information assessment, including market share, competitive position, industry and economic conditions, competitors' capabilities and products. 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 also considered. 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 systems 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. 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.

The *quality of management* is addressed. 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 not commonly discussed. We noted that there was little "pay for performance" analysis, in contrast to the findings of Kim and Schroeder [1990]. Exceptions include descriptions of stock option plans, the percentage of total compensation represented by incentives, or incentive plan descriptions. One report, a transcript of an analyst meeting with management, quoted a manager as follows:

> ... I have what we call management preferred, and it pays a dividend solely based on the performance of [the company's] common stock. Whether earnings go up or down, unless the shareholders make money based on the stock price, I receive nothing. My incentive is tied 100% to whether or not our shareholders make money.

Analysts also extensively disclose and evaluate corporate and management strategy (revenue growth, cost management, marketing strategy, competitive positioning, etc.). Analysts appear to signal high management quality through phrases such as "we believe that management is focused on shareholder value."

Analysts consider the effect of a company's anticipated changes on future earnings, including those related to products, projects, and restructurings, particularly related to identifying company trends. Directional phrases such as "change(s)," "increase," "decrease," "decline" and "new," occur thousands of times in the report data. The effect of product changes or new products, even when not yet marketed, are regularly assessed, particularly as to the company's ability to compete, and upon competing products, projected demand, revenue, and costs. Major projects, including modernization, acquisition, expansion, divestiture, and restructuring plans are evaluated, and their estimated effects are 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 are also addressed by the analysts. In addition, analysts report on the effect of share repurchase plans and planned issuances of new securities.

Phrases which focus on "acquisition" occur about 1,500 times in the 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 economies and earnings contribution.

Supplemental Findings

- ***Investor Economic Rationality***

Some analysts do not believe that investors are fully rational in an economic sense. For example, some analysts do not believe that investors have lengthy horizons in assessing company performance. One analyst 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."

- ***Analyst Reliance on Management***

Financial analysts rely heavily on management for information about their companies. Some analyst reports are largely transcriptions or summaries of a management presentation. Analysts report on "conference calls" to discuss earnings with management and other analysts, or on presentations and discussions at a company's annual meeting or at other meetings with analysts. The dependence by managements on financial analysts' recommendations for their companies provides an incentive for truthful disclosure of anticipated results. Analysts disappointed with negative earnings surprises regard future management earnings forecasts as less credible. At the same time, such disclosure to analysts raises questions about the unlawful "tipping" of information, and about the company's legal obligation to disseminate such information to the broader market [Coffee, 1993].

• ***Analyst Coverage of Companies***

Analyst coverage of large and small companies differs markedly. Larger companies receive better sell-side analyst coverage than smaller companies. For instance, we found no analyst reports for many of the "Small Cap" companies in our study. Analysts are aware of this, referring frequently to "poorly followed", "poorly understood", or "undiscovered" companies. This is consistent with previous research, such as Brennan and Hughes [1991], who reported findings that analyst following of corporations is directly related to firm size and inversely related to common stock price[11].

SUMMARY, LIMITATIONS, AND IMPLICATIONS

The contributions of this study include: (1) its extended application of content analysis to financial analysts' reports, (2) its assessment of such reports as related to accounting and financial reporting policy, as described earlier and (3) its pioneering use of a data source of analyst reports, Investext. Our content analysis of sell-side financial analysts' company reports suggests that contemporary financial reporting provides an important but incomplete basis for sell-side analyst forecasts of company performance. The reports we studied show that the information needs of analysts exceed traditional transaction-based reports. Sell-side 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. Some of the interesting findings include analysts': attentiveness to determining company core earnings; general assessment of assets at cost, and the circumstances in which market valuations of assets are used; diverse approaches to assessing company cash flows, including per-share calculations; identification of risks and concerns about companies; definition of earnings quality which is apparently different than definitions commonly assumed by accountants; and interest in earning momentum, echoing Ijiri.

Several features of our study should be kept in mind when considering its results. Analysts do not include all information considered in their reports. We do not know what information analysts used but did not report. We also do not know what sorts of information <u>might</u> be useful to analysts that were not available[12].

Analyst quality issues must also be considered. We operated from the view that over time competition will tend to reduce the occurrence of low quality analysts, making our population appropriate for study[13]. However, we recognize that the richness of the forecasting environment makes specific comparable performance measurement standards for analysts problematic: it is difficult to distinguish between luck (good and bad) and level of expertise. Even analysts who are highly regarded make poor recommendations on occasion [Leefeldt et al., 1992].

There are some who assert that user-needs based research is an incomplete basis for appraising accounting and financial reporting policy, as it can only provide "evolutionary", not "breakthrough" advances in financial reporting. For instance, it has been argued that prior to the invention of the electric light, assessment of "user needs" might have identified "brighter flame" or "smokeless wick" as needed improvements. However, the validity of such "Edison" analogies rests with perspectives on the identity of the inventor(s) of useful company information. If financial analysts are deemed to be such inventors, then it is important for accountants to study their information-use experiments and discoveries [Horngren, 1978].

Sell-side equity analysts also confront potentially serious and limiting conflict of interest questions [Lin and McNichols, 1992]. While most of the reports we examined contained a "disclosure" statement describing the positions held or the relationship with the reported-upon company, it is difficult to determine to what extent such conflicts affect the analysis. Future studies of sell-side analysts are needed to assist in understanding concerns about such potential objectivity issues and conflicts [Siconolfi, 1992].

Another concern emerging from this study is the lack of sell-side reports for small capitalization publicly traded companies which comprise an important part of capital market information demand. The parties who have an interest in such firms appear to be left to their own resources and to general purpose financial statements to ascertain information since analysts do not provide a ready source of guidance. This suggests that, in the small-cap market, sell-side analysis of company information cannot be relied upon as a source of price protection for unsophisticated equity investors.

The study also brought to our attention an important need for additional research of buy-side analysts' behavior. In what ways do buy-side and sell-side financial analysts differ in their evaluation of companies?

A concluding comment about the qualitative limitations of this study also seems in order. Attempting to infer the information needs of analysts and investors from this initial research effort would be heroic, particularly because our study was limited to investigating sell-side financial analysts. We acknowledge that there are constraints on our ability to rationalize the pattern of analysts' behavior for purposes of evaluating information content needs. Nevertheless, we hope that the research community's intellectual curiosity is stimulated by this study. Continued attempts to increase our understanding of the information needs of users will add to our knowledge and, potentially, to the value of the accounting product in a capital market environment comprised of many different types of investors.

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Table 1
Description of Sample

Panel A
Exchange Listings of Sample Firms

Exchange	Firms	Percent
New York Stock Exchange	115	35.17%
American Stock Exchange	48	14.68%
NASDAQ*	119	36.39%
Over-the-Counter	44	13.46%
Toronto Stock Exchange	1	0.31%
TOTALS	327	100.00%

* Including small cap issues.

Panel B
Industry Distribution of Sample Firms and Analyst Reports by One Digit SIC Code

Industry	Number of companies	Percent	Number of Reports	Percent
Agricultural, Forestry, and Fishing	1	0.31%	0	0.00%
Mining	14	4.28%	26	5.43%
Construction	2	0.61%	3	0.63%
Manufacturing	151	46.18%	238	49.69%
Transportation and Public Utilities	36	11.01%	59	12.32%
Wholesale Trade	10	3.06%	14	2.92%
Retail Trade	17	5.20%	31	6.47%
Finance, Insurance, and Real Estate	43	13.15%	66	13.78%
Services	34	10.40%	41	8.56%
No SIC Code Obtained	19	5.81%	1	0.21%
	327	100.00%	479	100.00%

Table 2
Brokerage Firms and Analyst Reports

Panel A
Brokerage Firms Sampled

Firm	Reports	Percent
Prudential-Bache Securities Inc.	54	11.27%
Merrill Lynch, Pierce, Fenner & Smith Inc.	35	7.31%
Donaldson, Lufkin & Jenrette Securities Corp.	34	7.10%
Shearson Lehman Hutton Inc.	33	6.89%
First Boston Corp.	33	6.89%
Kidder, Peabody & Co., Inc.	28	5.85%
Smith Barney, Harris Upham & Company, Inc.	27	5.64%
Oppenheimer & Company, Inc.	20	4.18%
Dean Witter Reynolds, Inc.	19	3.97%
Morgan Stanley & Co., Inc.	17	3.55%
PaineWebber Group Inc.	17	3.55%
Alex. Brown & Sons, Inc.	14	2.92%
The Bear Stearns Companies, Inc.	12	2.51%
AG Edwards	11	2.30%
Drexel Burnham Lambert, Inc.	11	2.30%
Piper, Jaffray & Hopwood Incorporated	10	2.09%
Salomon Brothers	10	2.09%
Kemper Financial Services, Inc.	9	1.88%
Fox-Pitt Kelton, Inc.	7	1.46%
J.C. Bradford & Co.	6	1.25%
Ladenburg, Thalmann & Co.	6	1.25%
Robert W. Baird & Company, Inc.	5	1.04%
Dain Bosworth	5	1.04%
Ragen MacKenzie	4	0.84%
Wheat First Butcher & Singer Inc.	4	0.84%
Dillon Read & Co., Inc.	4	0.84%
McDonald & Company Securities, Inc.	4	0.84%
Wertheim Schroder & Co., Inc.	4	0.84%
The Robinson-Humphrey Company, Inc.	3	0.63%
Rauscher Pierce Refnes, Inc.	3	0.63%
Johnson, Rice & Co.	3	0.63%
Sutro	3	0.63%
Scott & Stringfellow, Inc.	3	0.63%
Stephens, Inc.	3	0.63%
Raffensperger, Hughes & Company, Inc.	2	0.42%
Hambrecht & Quist, Inc.	2	0.42%
Tucker Anthony & R.L. Day	2	0.42%
First Analysis Corporation	1	0.21%
Janney Montgomery Scott Inc.	1	0.21%
Barclay's De Zoete Wedd	1	0.21%
Midland Walwyn Capital	1	0.21%
Cruttenden & Company	1	0.21%
William Blair & Company	1	0.21%
Interstate/Johnson Lane Corporation	1	0.21%
Gerard Klauer Mattison & Co.	1	0.21%
E.F. Hutton	1	0.21%
The Ohio Company	1	0.21%
Nonbrokerage firms included	2	0.42%
TOTALS	479	100.00%

Panel B
Frequency of Reports Downloaded

Time Periods Covered	Reports Downloaded by Company	Percent	Total Reports Downloaded
Zero	113	34.56%	0
One	50	15.29%	50
Two	63	19.27%	126
Three	101	30.89%	303
TOTALS	327	100.00%	479

Table 3

Search Words and Phrases

Panel A

Occurrence frequency of search phrases related to earnings predictability*

	earning(s)	revenue(s)
Predictability related phrases:		
consistent	2	3
predictability	4	0
stable	10	2
unpredictability	2	0
volatility	11	2
Core earnings related phrases:		
adjusted	13	14
base	18	31
core	10	1
on-going	4	0
operating	217	166
recurring	1	2
stream(s)	14	33

* Row and column terms comprise the search phrases to which the occurrence frequencies occur. For example "consistent" and "earning(s)" occurred two times, and "consistent" and "revenue(s)" occurred three times.

Panel B

Occurrence frequency of search words and phrases related to earnings quality**

Search word/phrase	Frequency
accelerated and depreciation	6
accrual(s)	66
allowance	29
bad and debt	26
conservative	227
conservatively	33
conservatism	8
credible	4
credibility	13
fifo	64
lifo	115
loss and provision	93
reserve	495
quality	403
uncollectible(s)	10

** Note: Occurrence frequencies refer to the absolute rates for words and phrases and may include irrelevant references. For example, many occurrences of the word "quality" referred to product quality, etc.

Notes

(1) Other recent work, including Knutson [1992], Elliott [1991], and Williams [1991] have explored the adequacy of financial reporting for contemporary stakeholders.

(2) Govindarajan examined the relative use of cash flow versus earnings information by coding each of the reports on a scale of 1 (cash flow oriented) to 6 (earnings oriented).

(3) Content analysis involves both quantitative and qualitative analysis of text. As described by Weber [1990, p. 49], content analysis "is a research method that uses a set of procedures to make valid inferences from text".

(4) Schipper specifically notes that company information contained in the analyst's report represents a "lower bound on the information items analyzed".

(5) The only large broker not contributing to Investext is Goldman Sachs. Therefore, a supplementary sample of full text Goldman Sachs reports were obtained and reviewed. These reports did not appear to differ from those of other analysts in general. We did not include the GS companies or reports in our sample or in our word or phrase databases.

(6) The content analysis software used was "WordCruncher", developed by Brigham Young University. It provides a frequency analysis of word and phrase use and enables searches and retrieval of terms in context of the full text.

(7) Quarterly income statements virtually never were presented without an annual income statement.

(8) Previous research on segmental disclosures includes Balakrishnan et al [1990], Baldwin [1984], Emmanuel and Garrod [1987], Mohr [1983], Rennie and Emanuel [1992], Senteney and Bazaz [1992], and Skousen [1970], among many.

(9) Panels A and B of Table 3 show only those search words and phrases that had a frequency of occurrence that was greater than 1. Search phrases such as "depreciation method" had no occurrences and are not listed in Table 1.

(10) Some (e.g. Bernstein (1989)) would argue that this form of earnings quality relates more cogently to capital maintenance.

(11) See also Bhushan [1989] and O'Brien and Bhushan [1990].

(12) To a great extent, this latter issue is addressed by the many studies that have surveyed analysts on their information needs.

(13) The quality of financial analyst forecasts is the subject of numerous studies, including Brown et al [1987], Dowen [1989],

Givoly and Lakonishok [1980], Grof et al [1979], and Ruland [1978], among many.

IV Content Analysis of Information Voluntarily Supplied by Companies to Users

IV Content Analysis of Information Voluntarily Supplied by Companies to Users

VOLUNTARY CORPORATE DISCLOSURE: WHO, WHAT, AND WHY?

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1. INTRODUCTION

This study investigates the extent to which public companies use voluntary disclosures to communicate with investors, creditors, and other stakeholders. Voluntary disclosures are defined as all disclosures beyond those mandated by the Securities Exchange Commission (SEC) and required to be reported under Generally Accepted Accounting Principles (GAAP). They include such items as the disclosure of additional financial and operating data, descriptions of the firm's long-term business and financial strategies, and discussions of the company's long-term prospects. We examine the frequency of these and other voluntary disclosures for a random sample of public companies and classify the types of voluntary disclosures that companies provide. We also investigate the characteristics of those firms that provide extensive and minimal disclosures.

Accounting research literature on voluntary disclosures help managers communicate more effectively with external suppliers of financing, thereby reducing their costs of capital.[1] Stockholders of public companies are typically dispersed and have limited access to information available to the firm's management. Of course, for such firms voluntary disclosure may not always be desirable for stockholders, since it may entail revealing proprietary data that is valuable to competitors. It may also be undesirable for managers that are sensitive about their performance and job security. Nonetheless, disclosure strategies potentially provide managers with an important means of communicating with investors, helping them to understand the firm's business strategies, and their implications for long-term performance.

Some argue that disclosure policies are likely to become particularly valuable as firms continue to invest heavily in intangible assets, such as quality improvement programs, human resource development, customer service, and research and

[1] For a summary of this literature, see " The Effect of Firms' Financial Disclosure Strategies on Stock Prices," by Paul M. Healy and Krishna G. Palepu, Accounting Horizons, March 1993.

development. These investments are typically not captured on a balance sheet, creating demand for alternative methods of reporting on these critical activities .

The results of our study indicate that there is considerable variation in disclosure across corporations. For example, there is a wide disparity in voluntary disclosures presented in mandated public reports, such as the annual and quarterly reports, and the 10-K statement. The highest rated firms provided extensive operating, financial and strategic information in these sources, whereas the lowest rated firms barely satisfied the level of disclosure required by GAAP or the SEC.

When companies make voluntary disclosures outside publicly-mandated reports, they typically use press releases and communication with financial analysts. The best rated disclosing firms provided a broad array of information in these disclosures, including additional financial data, strategic information, investment analysis data, management changes, and operating information.

We received details of *private disclosures* from only a small subset of the sample firms. However, the level of disclosure for these firms was impressive, perhaps an indication that only those firms with outstanding levels of private disclosures responded to our request for this data. These firms frequently included forecasts of future performance, financial details not available in public disclosures, and operating and strategic information. The most common target audience for these private disclosures was financial analysts and private creditors. Interestingly, the types of information provided to these groups is remarkably similar.

To examine whether managers view disclosures made in mandated public reports, through other public media, and through private sources as complementary or substitutes, we tested whether there is a positive or negative correlation between firms' ratings by the source of disclosure. Firms with high/low levels of voluntary disclosure in publicly mandated reports also tend to have high/low levels of stand-alone public disclosures. However, there is no statistically significant relation between the level of private and public disclosures, in part due to the small number of companies providing details of private disclosures.

Finally, we examined whether firms' characteristics are associated with their levels of disclosure. Firm size is an important explanatory variable for both forms of public disclosure ratings, those reported with mandated public documents and those reported as stand-alone information. Large firms are more likely to have high public disclosure ratings than small firms, consistent with the view that large firms are more likely to use public sources of financing, requiring provision of additional public disclosures to these owners. We also find that there is a non-linear relation between firm profitability and ratings of disclosures reported with mandated public reports with both highly profitable and loss-making firms providing extensive disclosures. One explanation for this finding is that managers of profitable firms provide additional disclosures to convince investors that they are responsible for their firms' success, whereas managers of firms that are unprofitable have strong incentives to explain to investors that the reasons for the poor performance stem from industry or economy factors, and not poor management.

The report is organized as follows. In section 2 we discuss the sample selection and present descriptive data for the test firms. We then describe the method of rating firms' disclosures. Section 4 discusses the results of our rating analysis, and presents preliminary evidence on firm characteristics associated with ratings. Finally, in section 5 we summarize our findings, and discuss their implications for future research.

2. SAMPLE SELECTION

Voluntary disclosure data for the sample companies was collected in cooperation with the Big Six accounting firms. Each company in the sample was first contacted by its audit partner and asked if they would be willing to participate in the study. We then followed up this request with a letter explaining the purpose of the study, the types of information that we were interested in collecting, and the disclosure period that we were studying (the calendar year 1991). Follow-up requests to firms that did not provide data after our first request were made through the audit partners. We believed that there were several advantages to this data collection approach. First, by accessing the sample companies through their audit firms, we hoped to increase the likelihood that we would receive a positive response from each company. Second, we restricted our event year to the most recent year available, increasing the likelihood that the data had not been discarded and would be easy to locate.

Our initial sample comprised 180 public firms selected from *Standard and Poor's Compustat*. To distribute the cost of approaching clients evenly among the Big Six accounting firms, we chose an equal number of sample companies for each Big Six firm. This was achieved by sorting the companies on Compustat by auditor and deleting all companies with a non-Big Six auditor. For each Big Six firm we then randomly selected 30 companies from the list of public clients. From these 180 firms, four could not be approached since they had changed audit firms. We received data from 56 of the remaining 176, a response rate of 31 percent.

Table 1 presents descriptive data on the final sample of 56 firms, and for the 120 non responding companies. There is a somewhat higher response from the largest firms in the sample. Forty-one percent of the firms with assets of more than $1 billion responded to our data request, whereas only 30 percent of the firms with assets less than $1 billion sent us data. There is no strong evidence of any industry response bias. As reported in Table 2, there is a heavy concentration of responding firms in the manufacturing sector (two digit SIC 30-39). However, a similar pattern is found (not reported here) for the non-responding firms.

To investigate other potential sources of bias in the responding sample, we collect data on firm size (market value) and profitability (net margins and return on assets) for the responding and non responding firms. Despite the differences in response rates between small and large firms, there does not appear to be a serious size difference between the responding and non responding firms. There is no significant difference in market value, or revenues per employee between the two sets of firms. There is also no evidence that the responding firms are significantly more profitable than the non-responding firms. Finally, we examine whether there is any evidence of selection bias by auditing firm. If audit firms make different recommendations to their clients as to disclosure policies, this could potentially confound our findings. However, there are no significant differences in response rates across the Big Six firms.

3. METHOD OF RATING DISCLOSURES

Our analysis requires that we develop a disclosure metric to rate each of the 56 test firms. Three broad sources of disclosures are identified from reading the materials we received from these firms: voluntary disclosures reported with publication of mandated public reports, stand-alone voluntary public disclosures, and voluntary private disclosures. Mandated public reports examined include annuals reports, SEC documents, and quarterly reports. Although firms are required to produce these reports, there is substantial scope for them to provide very different levels of voluntary disclosure in these documents. Stand-alone voluntary public disclosures include press releases, corporate brochures, and analyst reports.[2] Finally, private disclosures include presentations and information provided to credit rating agencies, analysts, banks, other financial institutions, private investors, and others.

We use a four point scale to rate disclosures by the test firms for each of the information sources discussed above. A rating of one indicates that the firm provides no voluntary disclosure for a particular information source. Firms receive a two rating if they provide only minimal voluntary disclosures. Firms with good levels of disclosure

[2] Even though analyst reports are not direct disclosures by corporations, we examine them because these reports contain disclosures made by corporations to analysts via meetings, teleconferences and telephone conversations.

receive a three rating, and firms with outstanding disclosure receive a four. The ratings are subjective -- they are based on the *style* of disclosures as well as their *content*.. Companies that use presentation styles, such as graphs and charts, to make their communication easier to understand receive a higher rating than firms that make no such efforts.

Below we report detailed descriptions of the types of disclosures provided by the sample companies, and the rating method. Our discussion is organized by the source of the disclosure. Aggregation of the ratings across the various sources of disclosure are simple averages.

3.1 Disclosures Reported with Mandated Public Reports

As noted above, there is considerable variation in firms' disclosures reported in mandatory public reports. We review the annual report, SEC filings (10-K, 10-Qs, and 8-Ks), proxy statements, and quarterly reports to shareholders to identify differences in the accompanying voluntary disclosures.

3.1.1 Disclosures in Annual Report

Companies are rated on the following disclosure dimensions: (1) financial highlights, (2) the message to shareholders and MD&A, (3) segment discussion, and (4) financial summary and footnotes. An aggregate annual report score is compiled as the equal-weighted average of the scores on the above dimensions. Below we discuss the dimensions in detail and the minimum and maximum levels of voluntary disclosure.

1. <u>Financial Highlights</u>

The financial highlights section is usually presented on the first inside page of the annual report, although it is sometimes merged with the compulsory minimum five years financial summary. At a minimum firms report revenues and net income for the past two years. However, many firms provided considerably more disclosure than this. The highest rated disclosure firms provided as many as five years of data, frequently presented in a graphical form, and a broad range of measures, including key performance measures (e.g.. revenues, profits, return on equity, net profit margin, and current ratio), and capital investments.

2. Message to Shareholders/MD&A

In the Message (letter from chairman/CEO) companies discuss their current performance, and report on their future prospects. At a minimum companies report the firms' revenues and profits for the year, with little explanation of the reasons for poor performance or future plans. The highest rated companies discussed new capital investment plans, strategic directions the company planned to pursue, and reasons for any current disappointing performance. In some cases this discussion was presented in a separate section, rather than in the Shareholders' Letter itself.

The MD&A presents the current year's performance in comparison with that of the past two years. At a minimum firms are required to compare the current year with the previous year, and then the previous year with its preceding year. The highest rated firms discussed all the three years performance together. They also provided detailed discussion on acquisitions, divestitures, production and pricing issues, government business, R&D, capital outlays, labor issues, products (including new products, pending products, and product backlogs), environmental issues, and other material items.

3. Segment Discussion

There are three types of segment disclosure - disclosure based on line of business, disclosure based on geographical segments, and product disclosure. This last is extremely rare in public reports. Segment disclosure can be found in different parts of the annual report. There is a section in the footnotes where companies are required to disclose segment data on revenues, income and identifiable assets. The most complete segment data is usually shown in the "Operating Review" section presented after the Message to the Shareholders. Three forms of variation in disclosure was identified. First, high disclosure firms grouped products into economically relevant groups, whereas low disclosure companies grouped products in non-intuitive ways, making the segment disclosures largely uninformative. Second, high disclosure companies reported more data items than required for each segment, including capital expenditures and working capital. Finally, the high disclosure firms provided detailed analysis of the performance for each division within a segment, market share and industry ranking data, as well as discussion of key competitors, new products, capacity, and capital plans.

4. Financial Summary and Footnotes

Footnote disclosure varied considerably across the sample firms. Low rated firms provided the minimum disclosures, a terse description of the major accounting methods followed, and a breakdown of required items (such as accumulated depreciation, and receivable allowances). The top rated firms provided comprehensive footnote disclosures on the effect of accounting method changes, subsidiary performance (especially for unconsolidated subsidiaries), tax issues (including US and foreign deferred taxes, reconciled statutory and effective rates, ITC data, and operating loss carryforwards), Information on debt outstanding (including the issuer, rate, maturity, and repayment schedule), financial tool usage (including exchange rate hedges, futures contracts, interest swaps, caps, and collars), contingent liabilities (particularly environmental issues), pension and postretirement liabilities (including funding status, projected benefit obligations, actual benefit obligations), lease information (including the type, terms, and repayment schedule).

Firms were also rated on their financial summary disclosures. At a minimum firms are required to provide five years of key information in a summary report. The highest rated firms provided ten or eleven years of data, and included key performance ratios and aggregated income statement and balance sheet data.

3.1.2 10-K Statement

The 10-K is the annual report that companies have to file with the SEC. There are two main differences between the 10-K and the annual report. First, the 10-K is a description of the corporation's major businesses and assets, its current position and recent performance, while the annual report is more focused on the current position and recent performance. Second, the 10-K is more structured, while the Annual Report is more "free form."

Companies are rated on the following dimensions for 10-K disclosures: (1) description of business, (2) description of property, (3) financial data and analysis (4) legal proceedings and auditor disagreements, and (5) information on executive officers. An aggregate annual report score is compiled as the equal-weighted average of the scores on these dimensions. Below we discuss the dimensions in detail and the minimum and maximum levels of voluntary disclosure.

1. Description of Business

Corporations are expected to include a historical background about the development of the business as well as a narrative description of the business with details about segments, competition, products, customers, suppliers, R&D, employees, backlogs, and financial information about domestic and foreign operations. The lowest rated firms provided terse statements with no data on segments, competition, products, suppliers, R&D, or foreign operations. The highest rated firms provided detailed statement on their businesses with extensive segment data, operating information, market share versus the a competition, and the names of major competitors.

2. Description of Property

Companies are required to report the location of principal plants and properties. Requirements for mining, oil and gas, and railroad companies are particularly detailed. For example, mining firms have to provide information on the location, size, yield, and expected lifetime for each of their mines. At a minimum companies report a perfunctory description of key properties. The highest rated disclosing firms reported a detailed schedule of all properties with details like location, rentals for leased properties, square-footage, and the appraised market values of their properties.

3. Financial Data and Analysis

Many firms satisfy these requirements by referring to the Annual Report. Ratings for these companies are therefore similar to the aggregated score for Annual Report disclosure. However, some companies provide greater details in the 10-K MD&A and financial statements than presented in the Annual Report. For example, they often report detailed schedules of Plant and Equipment in the 10-K. For these firms the Annual Report rating is adjusted to reflect the improved disclosure.

4. Disagreements with Accountants, Legal Proceedings

These two items represent potentially embarrassing issues for corporations. In our sample, we encountered several changes in auditor. These firms were given low ratings.[3] For firms with no auditor changes this category was unarmed. Legal proceedings are also seldom disclosed extensively. Few corporations actually provide

[3] We recognize that this is a simplistic assumption since auditor changes do not always signify disclosure problems.

data on potential losses under litigation, probably at the recommendation of the firm's lawyers. The lowest rated companies indicated that the firm cannot assess the exact potential liability, but that it is unlikely to be material. The best rated firms disclosed the exact nature and status of each of the legal proceedings.

5. Information on Executive Officers

Information on executive officers is typically discussed in the Proxy Statement, which is then referenced in the 10-K discussion. There is substantial conformity across companies in this disclosure. Most firms report the backgrounds of directors and executive officers, their relationships, remuneration packages, share holdings in the corporation, and transactions with the corporation. The highest rated firms provided considerable detail on the backgrounds of the directors, where the lowest rated companies provided few such details.

3.1.3 10-Q Statements

The 10-Q is the quarterly equivalent of the 10-K. However, 10-Qs are generally much less detailed than 10-Ks, both in the financial statement data reported and in the MD&A section. 10-Qs are also not audited. Finally, they have far fewer requirements than the 10-K. For example, there is no description of business, property, or executive officers.

There is little variation in voluntary disclosure in 10-Qs. Most of companies in our sample provided little information in their 10-Qs beyond that required by the SEC. The most significant differences arose in the MD&A discussion. The highest rated firms provide a comparative analysis based on both a quarterly and a year to date basis, whereas the lowest rated firms provided only a quarterly comparison.

3.1.4 Quarterly Reports

There is considerable variation across companies in disclosure presented in the quarterly report. At a minimum, the quarterly report shows financial highlights of the recent quarter and a brief description and analysis of performance in the quarter. The highest rated companies present detailed quarterly balance sheets, income statements, and cash flow statements, as well as complete discussions of performance, structural changes, and anticipated changes in outlook.

3.1.5 Examples of Good and Poor Disclosure in Mandated Reports

Six corporations received the maximum rating and four companies the minimum rating for disclosures accompanying public required reports. We present data for three of the high disclosure firms and one of the low disclosure firms to illustrate the rating method, and the variation in disclosures for the sample firms.

One of the highest rated disclosing firms is a large conglomerate whose primary lines of business are pulp, paper, and building products. The firm received the maximum rating in both disclosures released with mandated public reports and as stand-alone releases. The outstanding features of this corporation's disclosure are its annual and quarterly reports. Distinctive features include (a) extensive segment data and analysis., including breakdowns within segment across product lines; (b) in depth discussion of corporate strategy; (c) detailed eleven years financial summary, including condensed balance sheets and income statements; (d) operating statistics, including product capacities and production; and (e) excellent presentation with extensive use of graphical analysis. The 10-K is largely similar to the annual report. The discussion of legal proceedings is detailed, with a discussion of the exact position, prospect, likely outcome, and cost/benefit of each major item of litigation. The 10-Q has great depth of information by 10-Q standards, especially in the MD&A, and legal proceedings sections. Finally, the quarterly report includes all financial data from the 10-Q including footnotes, as well as segment data for the past four quarters.

The second highly rated company is a small multi-segment corporation manufacturing high altitude balloons, plastic films, and electronic controls. The company received the maximum rating for disclosures reported in mandated public reports and a 3 rating for public voluntary disclosure. Its annual report provides (a) excellent presentation of facts and figures through using charts, graphs and icons; (b) sales and profits broken down by segment, and within segments by product; (c) detailed analysis of performance carried out for each segment separately; (d) an eleven year financial summary; and (e) excellent coverage of stock performance, with data on both price and trading volume fluctuations. The quarterly report presents detailed segment data, which is rare for quarterly reports; excellent graphical representation of sales, income and equity; and financials based on quarters, year to date and trailing year, i.e. the last 12 months. Trailing year financial data was not observed in any other quarterly report.

The third company that received the maximum rating provides tax consulting, claims and refund filing, computer software, and temporary personnel hiring services. As in the above cases, the documents that stand out are the annual and quarterly reports. The annual report presents (a) detailed segment breakdowns of revenues, assets, depreciation and capital expenditures, (b) operating data, such as the number of customers for each segment and within segments for individual services; (c) an eleven year financial summary; and (d) excellent graphical representation of data. The quarterly report was rated highly because, in addition to detailed financial statements and analysis of performance, it included the transcript of the Annual Meeting.

In contrast to the above high rated firms, some companies provided virtually no disclosure. For example, one of the sample firms, a medium-sized manufacturer of precision equipment, provided barely enough data to meet the minimum standards laid down by the SEC. In the annual report there were no operating or segment data, the MD&A was sketchy, and though differences in performance over the years were discussed, there was little explanation for these differences. The financial footnotes were very concise and many areas like Accounting Methods and Loans were skimmed over. The 10-K was as also sketchy. For example, the business discussion section stated that the company:

> "actively competes with other machinery manufacturers, both domestic and foreign. The market for (our products) are subject to normal price, service and quality competition. Foreign manufacturers (primarily Japanese) continue to make serious inroads into the American market"

The 10-Q and the proxy statements for the company also conveyed no voluntary information.

3.2 Stand-Alone Voluntary Public Disclosures

Corporations use a variety of disclosure sources outside those mandated by the SEC and FASB to communicate with key stakeholders. These include press releases, analyst reports in the public domain, and corporate brochures. The rating method used for each of these are discussed below.

3.2.1 Press Releases

Press Releases are the most common form of stand-alone voluntary disclosure, public or private. Press Releases provide timely information given the lag between the tabulation of a company's results and the publication of their reports. They also provide management with a medium to report significant developments without waiting for the end of a reporting period.

There is considerable variance across companies as far as frequency and content of press releases. The lowest rated companies disclose only quarterly and annual results through press releases. The highest rated firms use press releases to disclose a host of operating and strategic information, including new product or service launches, top management changes, strategic alliances with other companies, major contracts won, major investments/divestments, and new stock/debt offerings.

3.2.2 Analyst Reports

Analysts' reports are based on private information that the corporations share with analysts. However, these reports themselves are in the public domain. They are hence a source of "indirect" public voluntary disclosure. Most of the analyst reports that we received follow a standard format. They largely emphasize stock performance and detailed ratio analyses. In addition, they usually include quarterly earnings estimates for the next several years. They typically conclude with a recommendation to buy, sell, or hold the stock.

Some analyst reports are extremely detailed. These correspond to companies which provided their analysts with very detailed data, or companies which have a public offering in the near future.

3.2.3 Corporate Brochures

Some firms prepare brochures on that summarize their businesses. The emphasis of these documents is usually operational, rather than financial. The lowest rated companies provided no such disclosures. The highest rated firms used this form of disclosure to review their historical background and divisional operations, report skills, capabilities and achievements, list strategic goals, products, services and major customers, and to present a financial summary.

3.2.4 Examples of Good and Poor Stand-Alone Public Disclosures

Four companies received the maximum score for stand-alone public disclosures. Two of these firms also received the maximum rating for disclosures in mandated public reports, and one received the maximum private disclosure rating.

One of the firms that received the maximum rating for stand-alone public disclosures is a small manufacturer of test and measurement systems for electronic and mechanical products. The company is financially in a precarious position, reporting large losses in the most recent year. Its disclosure rating in mandated public reports was below average. However, its press release and corporate brochure disclosures are particularly informative. For example, the press releases provide details of quarterly results and analysis; new products and services; new divisions and new technologies; business alliances; contracts and orders received; industry data; top management changes; NYSE stock ratings; and credit agreement with banks. The corporate brochure was technical in nature. It provided historical information about the products of the corporation, as well as information about the corporation's capabilities in the areas of electronic design, structural design, and printed circuit board testing.

Seven companies received the lowest rating for stand-alone public disclosures. One of these is a very small firm in the bulk drugs industry, whose disclosures consist of press releases and an investor fact sheet. The press releases present financial results but provide no analysis of performance or information about future prospects. The fact sheet is a summary of the past three years of financial data and some information about the company's products and prospects.

3.3 Private Disclosures

Most companies share sensitive and confidential information with private parties like banks, credit rating agencies, analysts, financial institutions and private investors. Unfortunately, the response from corporations in this category was disappointing. Less than 50% of the corporations that responded to our requests for information actually sent us any useful private information. Of the corporations that sent only public information (55%), around 30% claimed that they did not have any private information disclosure, while around 25% said that they could not share their private information with us. Hence, any conclusions we draw are based only on the smaller sub-sample of corporations that sent us private information.

We expected that the type of private information disclosed would depend on the identity of the private party for whom it was prepared. For example, an analyst is probably more interested in short term stock performance and would therefore be interested in earnings estimates. A prospective private investor would be more interested in the safety and return of his investment rather than short term return, and would like details of the corporation's asset portfolio. Credit rating agencies would probably expect more detailed information on all aspects of the corporation's operations to assess the credit rating of any instruments issued by the corporation.

However, we found that the nature of private information does not seem to vary with the recipient. The only difference lies in the packaging of the information, and the setting in which it is delivered to the different private parties. The setting varies from joint presentations for analysts, to individual presentations for credit rating agencies, to teleconferences for analysts and shareholders. Hence, corporations seem to believe in bundling private information and not customizing it for recipients.

Companies provide private disclosures on financial information, valuation data, operating information, and strategic information. The data we received was primarily in a written form. However, a few companies use teleconferencing to communicate with analysts. These firms provided us with tapes of these conferences. Because we have such a small sample of private disclosure firms, we do not rate firms based on private disclosures.

3.3.1 Financial Disclosures

Two forms of private financial disclosures are common. The first is the presentation of more detailed historical financial statements. These that present a more detailed picture of the previous financial periods. These include segment breakdowns and consolidating financial statements for large conglomerates. The second form of private financial disclosures is official company estimates of their future financial performance and position. These estimates are usually cast for a number of scenarios, based on different assumptions about the future. In addition, details of expected financial flows from individual projects are provided in some cases.

3.3.2 Appraisal Reports

Appraisal reports typically show market value estimates of the assets of the corporation. This is a disclosure instrument used frequently by corporations which have significant portfolios of fixed assets, for example corporations in real estate, logging mining, railroads etc. The appraisals are usually furnished by independent appraisers. In some cases firms recast their financial statements on the basis of estimated market values of the appraisals, and included these reports with the appraisal data.

3.3.3 Disclosures of Operating Information

This is another common form of private disclosure. Corporations provide private parties with more detailed data on operational aspects, including details of capacity, physical production, product sales, and market share.

3.3.4 Disclosures of Strategic Information

The strategic information that corporations provide usually accompanies their financial forecasts and is often in the form of three year or five year plans for the corporation. Strategic information includes a statement of goals, and objectives, as well as strategies that the corporation plans to undertake in order to achieve the goals and objectives. This includes information on operations, marketing, finance, technology, and human resources.

3.3.5 Examples of Good and Poor Private Disclosures

Fourteen companies received the maximum rating for the private disclosures. One of these is a small contractor that works on electronics contracts for the defense industry. The company received ratings of three for both forms of public disclosure. However, it provided detailed private information to banks, analysts, and credit rating agencies on its: (a) business plans, including estimates of revenues expenses, and profits for each month and product; (b) financial performance, including breakdowns by subsidiary; and (c) operating performance, reporting all contracts with quarterly and year to date variances, cost to completion, and expected profit.

Another company that provided excellent private disclosure is a large conglomerate that operates in a wide range of manufacturing and service sectors. It provided us with transcripts of presentations to analysts and fact books prepared for professional investors. Analyst presentations stressed increased dividends, capital expenditures, and book values. They also provided detailed segment information, including revenues, income, anticipated revenues, and prospects for each of the product/service lines. Finally, management used the presentations to explain key decisions, such as stock repurchases and changes in the status of joint ventures. The fact book for professional investors contains more financial information and less strategic or operating information. The financial information includes segment sales, income, assets, and ROE over the past 5 years, as well as stock related data.

A third company with high levels of private disclosure is a medium sized firm in the highway construction industry. The company targets private disclosures towards analysts and large private investors. The information disclosed to both target audiences is essentially the same, and includes (a) financial data and analysis for the past four years on a quarterly basis; (b) competitive analysis, with data on market share by industry and geographic operations; (c) data on the value of projects in hand, backlog, and progress on projects (with gantt charts and financial schedules); (d) a bidding schedule; and (e) discussion of future strategic directions and prospects.

Finally, one company received the lowest possible rating for private disclosure. This company is a small, loss making manufacturer of telecommunications equipment. Its private disclosure consists of a fact sheet mailed to analysts. The fact sheets contain a brief financial summary for the previous two years, stock price and volume data, and a list of reasons why the firm is a good investment. However, these reasons for investing are not substantiated by any data.

4. RATING RESULTS

All 56 of the sample companies enclosed their complete required public reports published for 1991. Of these companies, 51 enclosed copies of voluntary public disclosures not published with mandatory reports, and only 24 included copies of private disclosure documents. Below we present descriptive statistics on ratings for these firms. We also investigate several hypotheses to explain why some firms provide more comprehensive disclosure than others.

4.1 Descriptive Statistics on Ratings

Summary statistics on disclosure rating scores by disclosure source are reported for the sample firms in table 3. The ratings for voluntary disclosures in mandated reports and stand-alone public disclosures are quite similar. The first quartiles for both types of disclosure are 2.0, and the median and third quartile ratings are 3.0, implying that most firms provide moderate levels of disclosure. The ratings for private disclosures are substantially higher, with a median of 4.0, and a first quartile of 3.0. This difference is probably due to sample selection bias, since firms with outstanding levels of private disclosures are more likely to respond to our request for data.

Table 4 summarizes the source of disclosure and the types of disclosure for the 51 firms that provided information on stand-alone public disclosures. The most common form of disclosure, provided by 47 firms, is press releases. Other forms of disclosure include analyst reports (provided by 12 firms), annual meeting transcripts (provided by 16 firms), and company brochures (provided by only 7 firms). The firms report a broad array of information in these disclosures. Most present additional financial data (48 firms of the 51 firms). Strategic information (25 firms), investment analysis (28 firms), management changes (22 firms), and operating information (18 firms) are also popular topics of the disclosures.

A summary of the target audiences and content of private disclosures is presented in table 5. As noted earlier only 24 companies provided us with private disclosures. The most common target for these disclosures is financial analysts (17 firms) and private creditors (11 firms). These disclosures typically include forecasts of future performance, financial details not available in public disclosures, as well as operating and strategic information.

Finally, we explore the relation between the different types of disclosures. This enables us to test whether firms with low levels of public disclosure, provide high levels of private disclosure, perhaps to prevent providing useful information to competitors. If such is the case, there will be a negative relation between the level of public and private disclosure. Alternatively, if some firms provide high levels of disclosure across all categories, and other low levels, there will be a positive relation between the levels of disclosure from public mandated sources, stand-alone public sources, and private sources. In table 6 we present a correlation matrix for disclosure rating scores by the source of disclosure. Firms with high/low levels of voluntary disclosure in publicly mandated reports also tend to have high/low levels of stand-alone public disclosures. There does not appear to be a significant positive or negative relation between the level of private and public disclosures. This may be due to the small number of firms that provided us with private disclosure data.

4.2 Factors Explaining Voluntary Disclosures

Disclosure models imply that firms' disclosure levels are determined by several factors, including (a) demands for new capital, (b) the proprietary nature of information, and (c) agency conflicts between managers and owners.

Firms for which internally-generated funds are unlikely to meet new investment opportunities have a strong incentive to provide high levels of disclosure to attract new capital. These disclosures could be public disclosures if the firm intends raising funds in public debt or equity markets, or private disclosures if the source of new funds is private capital. If managers maximize shareholder wealth, these financing and disclosure decisions will be determined by the nature of the firm's investment opportunities. When disclosing investment details provides valuable information to competitors, managers are more likely to access private sources of capital and disclose the details of the investments privately to these investors. Alternatively, when investment information is not valuable to competitors, managers are likely to prefer to raise new capital in the highly liquid public debt and equity markets, necessitating additional public disclosures.

Of course, managers do not always act to maximize shareholder wealth. If there are conflicts of interest between managers and owners, which cannot be completely resolved through compensation contracts or equity ownership, managers are likely to provide limited public disclosures to avoid having to reveal information about poor job performance if the firm's fortunes decline. Managers might justify this low level of disclosure by arguing that disclosure of additional information is not in shareholders interests, since it is proprietary.

Below we examine the relation between disclosure ratings for our sample firms and a number of firm and industry characteristics. Where possible we discuss how these variables could proxy for the above theoretical determinants of firms' disclosure decisions discussed above. The variables considered are: (a) firm size; (b) firm profitability; and (c) the degree of competition in the firm's industry.

Firm size is often alleged to be important in explaining disclosure. Large firms are likely to have more disperse public ownership than small firms. Large firms are therefore likely to provide disclosures in public forums, whereas small firms will present additional disclosure in private sources. This implies that: firm size should be positively related to the level of public disclosure, and negatively related to private disclosure ratings. We use the log of book value of total assets as a measure of firm size.[4]

There are several reasons why firm profitability might affect the level of disclosure. First, managers of more profitable firms are likely to make additional public disclosures to advertise their own managerial success. Alternatively, highly profitable firms may be reluctant to make extensive public disclosure to avoid reporting information that would help their competitors replicate their success. The sign on the relation between public disclosures and profitability is therefore uncertain. Return on assets is used as a measure of firm profitability.[5]

If firms in more competitive industries are more concerned about disclosing proprietary information to competitors, there will be a negative relation between the level of public disclosure and the degree of industry competition.

To test whether the above variables explain firm disclosure ratings, we estimate three multivariate regressions using firm ratings for disclosures included with mandated public reports, stand-alone public disclosures, and private disclosures as dependent variables. The independent variables in these regressions are the log of assets, return on assets, and the degree of industry competition. Specification tests indicate that there is a

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[4] Two alternative measures of firm size, revenues and the market value of equity, were also used. The results using these measures are similar to those reported in the paper.

[5] We also use net margin (net income divided by sales). The results are not materially different using this alternative measure of profitability.

nonlinear relation between ratings of disclosures presented with mandated public reports and return on assets. We allow for this nonlinearity in the model by including the squared return on assets variable as an independent variable in this model. The results of our analysis are reported in table 7.

Firm size is an important explanatory variable for both forms of public disclosure ratings, those reported with mandated public documents and those reported as stand-alones. As expected, large firms are more likely to have high public disclosure ratings than small firms. This is consistent with the view that large firms are more likely to use public sources of financing, requiring provision of additional public disclosures to these owners. There is no significant relation between firm size and private disclosure ratings. This may reflect the small number of observations available for this model.

Firm profitability, captured by return on assets, is significantly related to ratings of disclosures reported with mandated public reports. As noted above, the relation is non-linear, implying that both highly profitable and loss-making firms provide extensive voluntary disclosures. Managers of profitable firms are likely to provide additional disclosures to build reputations as effective managers, and to convince investors that they are responsible for their firms' success. Managers of firms that are unprofitable have strong incentives to explain to investors that the reasons for the poor performance stem from industry or economy factors, and not poor management. There is no significant relation between firm profitability and stand-alone public, and private disclosure ratings.

Finally, there is no significant relation between the number of competitors in an industry and the level of disclosure. This suggests that either the degree of competition in the industry is not a good proxy for the potential competitive costs of disclosure, or that competitive concerns are not important determinants of the disclosures we examine.

5. CONCLUSIONS

The results of our study indicate that there is considerable variation in disclosure across corporations. For example, there is a wide disparity in voluntary disclosures presented in mandated public reports, such as the annual and quarterly reports, and the 10-K statement. The highest rated firms provided extensive operating, financial and strategic information in these sources, whereas the lowest rated firms barely satisfied the level of disclosure required by the FASB or SEC.

When companies make voluntary disclosures outside publicly-mandated reports, they typically use press releases. The best rated disclosing firms provided a broad array of information in these disclosures, including additional financial data, strategic information, investment analysis data, management changes, and operating information.

We received details of private disclosures from only a small subset of the sample firms. However, the level of disclosure for these firms was impressive, perhaps an indication that only those firms with outstanding levels of private disclosures responded to our request for this data. These firms frequently included forecasts of future performance, financial details not available in public disclosures, and operating and strategic information. The most common target audience for these private disclosures was financial analysts and private creditors. Interestingly, the types of information provided to these groups is remarkably similar.

To examine whether managers view disclosures made in mandated public reports, in the financial media, and through private sources as complementary or substitutes, we tested whether there is a positive or negative correlation between firms' ratings by the source of disclosure. Firms with high/low levels of voluntary disclosure in publicly mandated reports also tend to have high/low levels of stand-alone public disclosures. However, there no significant relation between the level of private and public disclosures, in part due to the small number of companies providing details of private disclosures.

Finally, we examined whether firms' characteristics are associated with their levels of disclosure. Firm size is an important explanatory variable for both forms of public disclosure ratings, those reported with mandated public documents and those reported as stand-alones. Large firms are more likely to have high public disclosure ratings than small firms, consistent with the view that large firms are more likely to use public sources of financing, requiring provision of additional public disclosures to these owners. We also find that there is a non-linear relation between firm profitability and ratings of disclosures reported with mandated public reports with both highly profitable and loss-making firms providing extensive disclosures. One explanation for this finding is that managers of profitable firms provide additional disclosures to convince investors that they are responsible for their firms' success, whereas managers of firms that are unprofitable have strong incentives to explain to investors that the reasons for the poor performance stem from industry or economy factors, and not poor management.

Although these findings provide some evidence on the variation in disclosure across companies, and the types of disclosures provided by high rated companies, they should be interpreted with caution. As discussed above, the number of firms surveyed is limited. This is particularly relevant for the analysis of private disclosures, where the number of firms that provide complete information is very small, and likely to be biased. In addition, the rating mechanism is qualitative, raising questions about whether our classifications would be replicated in an independent study.

Nonetheless, we believe that our work provides a useful starting point for future empirical research on disclosure. Prior empirical work has used analyst ratings of disclosure as a proxy for firms' disclosure levels. However, these ratings tend to be available for only the largest and most well-known firms. More extensive analysis of disclosure will require extending the analysis to small companies, where communication problems are likely to be most severe. The approach followed in this study provides a potential design that could be implemented for this purpose. Disclosure ratings could then be used to answer the following questions: do firms that provide high levels of disclosure receive any benefit in terms of a lower cost of capital? and how important are competitive factors in explaining firms' decisions to withhold or disclose information?

Table 1
Descriptive statistics on the disclosure and non-disclosure samples

	Mean for	
	Responding sample (56 firms)	Non-responding sample (120 firms)
Market value	\$965m	\$1,319m
Sales per employee	\$216,000	\$147,000
$\frac{\text{Debt}}{\text{Assets}}$	67%	77%
$\frac{\text{Net income}}{\text{Revenues}}$	2.5%	3.4%
Return on assets	1.5%	2.7%

Table 2

Industry composition of responding sample

SIC	Industry Name	Responding sample (56 firms) Number	Percent
00-19	Agriculture, forestry, mining, oil	8	15%
20-29	Food, textiles, chemicals, petroleum	10	18
30-39	Rubber, metal, electrical, and transport equipment	17	31
40-49	Utilities	7	12
50-59	Durables, nondurables, retail	5	9
60-69	Finance, real estate	3	5
70-79	Miscellaneous services	3	5
80-89	Health, legal, social services	3	5
Total		56	100%

Table 3

Descriptive statistics on disclosure ratings in 1991 by form of disclosure for 56 public firms with Big Six auditors

	Form of voluntary disclosure		
	Disclosures in mandated public reports	Stand-alone voluntary disclosures	Private disclosures
Mean	2.6	2.5	3.4
Median	3.0	3.0	4.0
Q1	2.0	2.0	3.0
Q3	3.0	3.0	4.0
Standard Deviation	0.8	0.8	0.8
Minimum	1	1	1
Maximum	4	4	4
Number of observations	56	51	24

Table 4

Summary of the source and type of information disclosed for stand-alone public disclosures

	Number of firms	Percentage of sample that included stand-alone disclosures
Panel A: Source of disclosure		
Press releases	47	92%
Company brochures	7	14
Analyst reports	12	24
Annual meeting transcript	16	31
Panel B: Content of Disclosure		
Financial results	48	94%
Operating information	18	35
Top management change	22	43
New business relations	11	22
New investments	28	55
Strategic information	25	49

Table 5

Summary of the target audience and type of information disclosed for private disclosures

	Number of firms	Percentage of sample that included private disclosures
Panel A: Target audience		
Private creditors	11	46%
Analysts	17	71
Credit rating agency	5	21
Panel B: Content of Disclosure		
Future forecasts	17	71%
Financial details	19	79
Operating information	19	79
Strategic information	17	71

Table 6

Relation between 1991 disclosure ratings from different sources for a sample of 56 public firms with Big Six auditors

	Form of voluntary disclosure		
	Disclosures in mandated public reports	Stand-alone voluntary disclosures	Private disclosures
Disclosures in mandated public reports	1.0		
Stand-alone voluntary disclosures	0.45	1.0	
Private disclosures	0.25	0.19	1.0

Table 7

Relation between disclosure ratings and firm characteristics for a sample of 56 public firms with Big Six auditors

Independent variables	Coefficients (t statistics) for models with following dependent variables:		
	Rating for disclosures in mandated public reports	Rating for stand-alone voluntary disclosures	Rating for private disclosures
Constant	1.85 (4.7)[a]	1.45 (3.2)[a]	2.3 (2.5)[a]
Log of assets	0.18 (4.3)[a]	0.15 (2.7)[a]	0.08 (0.9)
Return on assets	0.018 (2.2)[b]	0.003 (0.3)	0.022 (0.6)
Return on assets squared	0.001 (2.7)[a]	-	-
Degree of competition dummy	-0.15 (-1.1)	0.10 (0.6)	0.24 (0.9)
Adjusted R^2	0.27	0.09	0.00
Number of observations	56	51	24

[a] Significantly different from zero at the one percent level using a two tailed test.

[b] Significantly different from zero at the five percent level using a two tailed test.

V Survey of Investors and Creditors

V Survey of Investors and Creditors

The AICPA
Special Committee
on Financial
Reporting

Impact of the Harris Survey on Users' Needs Subcommittee's Analysis of Users' Needs for Information

July 14, 1994

July 14, 1994

Background

The Users Needs Subcommittee of the Special Committee prepared a summary document *Users' Needs Subcommittee–Analysis of the Information Needs of Investors and Creditors* (the Users' Needs Analysis *or* the Leading Views), based on the Subcommittee's review of various documents and discussions with professional investors and creditors. The Users' Needs Analysis presented both the leading views of users, as well as, alternative views. A follow-up survey on user's needs was performed by LH Research of New York. Lou Harris was primarily responsible for the resulting summary document, *A Survey of Investors and Creditors About Their Information Needs* (the Harris Survey).

In general, the Harris Survey asked multiple choice questions, soliciting "degree" responses ranging from **Agree Very Strongly** to **Disagree Strongly**. Based on recommendations by Mr. Harris, the subcomittee considered an answer to be significant if (1) at least 50% of the responses **AGREED** with a point <u>and</u> (2) at least 25% of the responses **AGREED STRONGLY**. In areas where general questions contradicted specific questions, more weight was given to the specific questions.

Analysis

This analysis of the Harris Survey is organized by questionnaire topic. In general, similarities with leading views are not comprehensively identified in this analysis.

Disaggregated Information

The Harris Survey and the leading views are generally consistent regarding disagregation; however, two sub-areas were not consistent. One of the questions posed to the investors and creditors asked if companies should provide disaggregated information based on geographic segments (note, creditors were below the 25% threshold for strong concurrence, while investors were above the threshold) and another asked if companies should determine segments based on internal segmentation. In both cases, these ideas were leading views but did not meet the 25% threshold for strong concurrence. The Committee need not resolve these issues since the FASB is currently in the midst of a major project on disaggregation and these sub-issues have been identified as components of that project.

Fair Value Information

The Harris Survey indicated more interest in the use of Fair Value to measure Financial Instruments than earlier findings. The interest in measurement of Financial Instruments falls within the 25% threshold for strong concurrence (at 28%). Although a slight majority of users appeared to support the use of fair value measurements for productive assets and 62% supported disclosure about fair value of productive assets, neither reached the 25% level. It should be noted that the survey only asked general questions in this area, while the Committees' earlier research into users' needs was much more specific. The subcommittee continues to believe the leading views on this matter are indicative of users needs.

Alternative Accounting Procedures

The Harris Survey responses to a general question regarding the need for only one method of accounting for a transaction or event were inconsistent with leading views but when questions were asked about specific areas (such as inventory, business combinations, and depreciation) the answers were consistent. The answers to specific questions provide more valuable information than those to a general question. As a result, the investors and creditors in the Harris Survey were consistent with the leading views. The Committee should retain the leading view that alternative procedures for inventories, depreciation, and business combinations do not cause serious problems for users.

The respondents to the Harris Survey supported capitalizing all leases, although the support was not overwhelming (it did not meet the 25% threshold). The Committee should continue to support the leading view, but should note this interest in capitalizing leases in the broader context of user concern and confusion over off-balance sheet financing arrangements.

Reporting of Measurement Uncertainties

Again, the Harris Survey responses to general questions were inconsistent with the leading view, but when questions were asked about specific areas the answers were consistent. As with the notion of alternative accounting procedures, the Committee should continue to support the leading view.

Interim Reporting

In response to a general question, less than a majority (with less than 20% feeling strongly) indicated a need for improvements on timeliness or content of interim reporting, although the response was much stronger for specific areas. A slight majority of investors and creditors in the Harris Survey supported the ideas of including uncondensed financial statements in interim reports and including quarterly cash flow statements in place for year-to-date cash flow statements, which is consistent with the leading views. However, the strength of the interest in these two areas did not meet the 25% threshold. The strength of interest in the area of including a "rolling twelve month" income statement in the quarterly statement did not meet either the majority or the 25% threshold.

The Committee should consider whether to continue to suggest significant changes in interim reporting.

Nonfinancial Business Information

Investors and creditors in the Harris Survey were split on the general notion of expanding disclosures of non-financial information. As with other general questions, when asked specifically, the investors and creditors indicated that certain nonfinancial information (e.g., business description, managements' discussion and analysis, related parties, and industry structure) was either essential or useful.

The Committee should challenge whether certain nonfinancial disclosures such as mission, broad objectives and strategies have sufficient support to be retained in the comprehensive model.

Forward Looking Information

On the general question of expanding forward looking information, the survey did not support expansion principally because those surveyed believed they had adequate sources of such information. The Harris Survey view on projections is consistent with the leading views that they were not needed; however, related expansion of forward looking information was inconsistent. Consistent with leading views, certain items (factors or conditions internal to the company that are critical to achieving its objectives; Major plans for future activities) were deemed essential. While other items (trends, opportunities and risks, and comparisons of actual to previously disclosed forward looking information) were only considered helpful.

Differential Reporting

Consistent with the leading view, the survey indicates that, in general, both public and private companies should follow the same rules regarding the form and content of footnote disclosures. However, the question regarding private company's provision of nonfinancial information being subject to negotiation while supported by the survey, did not reach the 25% strongly agree threshold. We recognize that differential disclosure is born more in the idea of cost benefit rather than in users' needs and as such the answers may have been focused from a different prespective than the Committee had intended.

Trade-off's

Sixty percent of the Harris Survey participants indicated a willingness to cut back disclosures of less useful items to make room for new changes in external reporting. The subcommittee remains very interested in this notion and believes that the Committee should include this idea as an integral recommendation of its final report.

Auditor Association

With respect to the questions of auditor commentaries in addition to the standardized report, Survey responses varied in the degree of interest in such commentaries. Auditor commentary on <u>accounting principles</u> gained significant support, however, commentary on <u>measurement uncertainties</u> and <u>opportunities and risks</u> had less support (the 25% threshold was not met). The degree of interest in certain areas differs from the leading view that the commentary was desired for all these areas. In as much as the Committee has decided to forward its observations on auditor commentary to the new special committee on auditor assurance, no further changes to the Comprehensive Model or Auditor Assurance recommendations are needed.

Conclusion

Overall, the Harris Survey was generally consistent with the "Leading Views" of the Users' Needs Subcommittee summary with a high level of interest in Disaggregation, Financial Instruments and Off-Balance Sheet Risk, and Disclosures about Unconsolidated Entities.

Results of the Survey

STUDY 930022

A SURVEY OF INVESTORS AND CREDITORS ABOUT THEIR INFORMATION NEEDS

Prepared for
The AICPA Special Committee on Financial Reporting
March 1994

Conducted by
LH Research Inc.*
Study Director
Louis Harris

*Not affiliated with Louis Harris and Associates

A WORD ABOUT THIS STUDY

The American Institute of Certified Public Accountants Special Committee on Financial Reporting retained the national survey research firm of LH Research, Inc. to conduct this study of the attitudes of 1204 key investors, creditors, and their advisors, together referred to as users, who constitute major users of financial data released by public and private corporations in the United States.

The Special Committee was formed in the Spring of 1991 to address increasing concerns about the usefulness of external reporting by companies to investors and creditors. The Committee is in the final stages of making recommendations to more closely align external reporting with the needs of the users of such information. The Committee's recommendations could impact in important ways what is currently provided by companies in annual reports, 10K's, 10-Q's, 8-K's, and Proxy Statements. Both the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission have closely followed the work of the Special Committee.

The survey conducted by LH Research is designed to help the Committee determine the information needs of users and what changes in disclosure and measurement are felt to be most needed to provide the best flow of information to help capital markets work most effectively.

In all, 1204 investors and creditors were surveyed by specially trained executive interviewers of LH Research, operating under the supervision of field executive Susan Erb. Of the final sample, 60% came from the investment side and 40% from the creditor side. This 60-40 split was a reflection partially of the lists available for interviewing and the fact that within creditor institutions, such as banks and insurance companies, there is a considerable body of investment activities. With the relatively small universe from which this sample was drawn, the sampling error of the total sample is estimated to be 2.5 percentage points in 95 out of 100 cases.

The size of the sample was changed after the questionnaire was drafted and tested. Originally, the full questionnaire was to be administered to a total sample of 600 creditors and investors. However, because the questionnaire was running as long as 50 minutes in the test, it was decided to double the sample size to 1200 and to ask all of 1200 the first 13 questions dealing with 12 pivotal issues the Special Committee was addressing. Then the remaining questions were split, with half being administered to half the sample and the other half with the remaining half of the sample. The sampling error for the 531 who were given the "A" version of the questionnaire and the 673 who were administered the "B" version is estimated to be 3.5 points in 95 out of 100 cases. Copies of the questionnaires are at the end of this report.

The distribution of the sample by classification reflects a broad spectrum:

CLASSIFICATION OF THOSE INTERVIEWED

	Total %
Equity Analyst	32
Equity Portfolio Mgr.	29
Debt Analyst	7
Credit grantor	23
Debt portfolio manager	8
Not recorded	1

The users focus on the following industries:

	Total %
No particular industry specialty	54
Manufacturing	7
Consumer products	6
Financial institutions	24
Other services	10
Energy and mining	5
Real estate	4
Start-up high technology	5
Not recorded	2

Note: The reason for the high "no particular industry" category is that a sizable number of respondents are active in a number of industries.

The lists which were obtained and provided the basis for the sampling were: the membership of the Association for Investment Management and Research (AIMR) and the Securities and Exchange Directory of Registered Investment Advisors, the creditor list from Robert Morris Associates, and a list of banker creditor executives from the American Bankers Association, drawn from institutions with over one billion dollars in assets. A random-selection procedure was followed on all lists, with an interval selected initially along with a random starting number to insure that each investor or creditor on the list would have an equal chance of being drawn in the final sample. In all, roughly one third of those contacted did not complete the interviews, some, mainly in the investment area, because suddenly a market development or a particular sell or buy opportunity presented itself and they had to cut off, and others because of time conflicts.

The questionnaire was written by Louis Harris, who was in charge of the study from inception to completion. However, the questionnaire went through several versions, due to the fact that it had to be reviewed by certain Committee members, and which then was tested extensively by the able Susan Erb and her staff. The professional responsibility for the instrument is that of Mr. Harris.

The study was conducted in two parts. Each individual was first contacted and was given a relatively brief explanation of what the survey was about and for whom it was being conducted. Then a six page preinterview briefing paper, included in the section with the questionnaires, defining the parameters of the study and also the terms used in the questions, was sent to each individual. Then a date was made for the interview. The average interview lasted 30 minutes.

The policy of LH Research, which Mr. Harris has followed throughout his professional career is that if one part of the study is released publicly, then the entire study must be released. This policy is being followed in this case.

ANALYSIS

Disclosure of Disaggregated Information

Each person surveyed was asked how strongly they felt that "improvements are needed in disclosures of disaggregated information:"

Q1.EXPANDING DISCLOSURES OF DISAGGREGATED FINANCIAL INFORMATION

	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	78	82	72	88	75	85	67	76
Feel very strongly	41	46	32	51	41	51	26	36
Feel somewhat strongly	37	36	40	37	34	34	41	40
Feel not very strongly	10	9	13	5	12	7	16	13
Believe no change is needed	10	9	12	5	12	7	15	10

These results indicate that a rather decisive 78% majority of all the executives surveyed believe that change in disclosures of disaggregated information are needed. Further, 41% say they feel "very strongly" about such changes. As a general rule, respondents indicate a strong desire for change whenever the percentage in the "feel very strongly" category exceeds 25 percent. Finally, only about 10% say that they feel "no change is needed," indicating again that disaggregated information is an area for the Special Committee to address in its recommendations.

The survey subsequently asked about 17 specifics in the area of disaggregated information:

Q13.SPECIFIC VIEWS ABOUT DISCLOSURE OF DISAGGREGATED INFORMATION

	Total Agree	Agree Strongly							
		Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%	%
Companies should report disaggregated information based on industry segments	92	48	57	35	61	50	58	26	43
Companies should determine geographic segments based on the location of the markets in which they sell products or services.	85	42	48	34	47	48	39	32	37
Companies should report disaggregated information based on individual product lines, even if those lines are narrower than industry segments, if those product lines are important drivers of the company's opportunities and risks.	83	39	45	29	45	46	47	25	29
Companies should report nonfinancial business information along the same lines that they report segment financial data. Thus, for example, management's discussion and analysis of operations should be organized according to the company's business segments rather than based on the company as a whole.	80	31	35	26	37	32	25	26	29
Many companies now report too few industry segments	77	35	41	26	44	38	36	20	37
Companies should at least consider how analysts attempt to segment the company when deciding on industry and geographic segments.	75	29	33	25	35	30	36	22	23
Companies should report disaggregated information as a part of any quarterly reports issued.	72	25	31	17	33	28	33	14	9
Companies should report disaggregated information based on geographic segments.	67	22	29	11	33	24	22	8	9
Companies should report disaggregated information based on the individual legal entities that comprise the company.	67	26	21	34	22	20	33	37	23
Companies should determine industry and geographic segments based on how the company segments itself internally for reporting to senior management or the board of directors.	59	19	23	12	23	23	17	12	9

Q13.SPECIFIC VIEWS ABOUT DISCLOSURE OF DISAGGREGATED INFORMATION (Cont.)

	Total Agree %	Agree Strongly: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
Many companies now report too few geographic segments.	57	18	20	16	21	18	17	15	17
Users need complete financial statements for each industry and geographic segment.	56	17	19	15	22	15	17	13	17
The level of detail of financial informa- ion about industry and geographic segments that companies report today is about right for my purposes.	53	9	10	8	11	8	6	10	6
Companies should determine their industry and geographic segments based on how competitors report their segments.	48	10	11	8	10	12	14	7	6
As a practical matter, companies should disclose segment financial data at the same level of detail that senior management uses to manage the business.	45	16	20	10	22	18	11	11	6
As a practical matter, companies should limit the segment financial data that they disclose to a handful of key statistics, as they do now.	40	9	7	11	7	7	3	12	14
Companies should determine geographic segments based on the location of their production facilities.	33	5	7	3	10	4	6	2	--

Out of the 17 specific suggestions put forth for test in this study on disaggregated information, fully 8 are agreed to by both a majority of the investors and creditors and are strongly agreed to by 25% or better:

-- A substantial 92% agree to and 48% agree strongly that "companies should report disaggregated information based on industry segments.

-- 85% agree and 42% agree strongly that "companies should determine geographic segments based on the location of the markets in which they sell products or services."

-- 83% agree and 39% agree strongly that "companies should report disaggregated information based on individual product lines, even if those lines are narrower than industry segments, if those product lines are important drivers of the company's opportunities and risks."

-- 80% agree and 31% agree strongly that "companies should report nonfinancial business information along the same lines that they report segment financial data. Thus, for example, management's discussion and analysis of operations should be organized according to the company's business segments rather than based on the company as a whole."

-- 77% agree and 35% agree strongly that "many companies now report too few industry segments."

-- 75% agree and 29% agree strongly that "companies should at least consider how analysts attempt to segment the company when deciding on industry and geographic segments."

-- 72% agree and 25% agree strongly that "companies should report disaggregated information as a part of any quarterly reports issues."

-- 67% agree and 26% agree strongly that "companies should report disaggregated information based on the individual legal entities that comprise the company."

Fair Value information in Financial Statements and Related Footnote Disclosures

The study asked about fair value information in financial statements and related footnote disclosures. It pointed out that some assets and liabilities recognized on the balance sheet are measured at historical cost and others at fair value, and that footnotes must disclose the fair value of financial instruments, regardless of how those instruments are measured on the balance sheet. In all, three questions deal with this area. The first deals with measurement of assets and liabilities on the balance sheet. Each user was asked how strongly he or she felt that "the use of fair value accounting should be expanded to include more types of financial instruments measured at fair value than in current practice." These instruments include such items as receivables, investments in securities, payables, and debt. They exclude items such as inventory, property, plant and equipment. Here are the results:

Q2a.EXPANSION OF USE OF FAIR VALUE ACCOUNTING TO INCLUDE MORE TYPES OF FINANCIAL INSTRUMENTS THAN MEASURED AT FAIR VALUE IN CURRENT PRACTICE

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	62	67	53	68	66	61	48	61
Feel very strongly	28	34	20	36	31	18	20	22
Feel somewhat strongly	33	34	33	33	35	43	28	39
Feel not very strongly	18	16	21	13	19	22	22	15
Believe no change is needed	19	15	25	17	13	17	28	23

Here the support is not as strong as in the case of disclosure of disaggregated information. A majority of 62% agrees that fair value accounting should include more types of financial information, and 28% feel very strongly about it. Investors feel stronger about the issue than do creditors.

A second question in this area also relates to the measurement of assets on the balance sheet. Specifically, it relates to all assets other than financial instruments, such as inventory, property, intangible assets, and other productive assets. The users were asked how strongly they felt about expanding fair value accounting to include more types of such productive assets than is the case today:

EXPANSION OF USE OF FAIR VALUE ACCOUNTING TO INCLUDE MORE TYPES OF PRODUCTIVE ASSETS THAN MEASURED BY FAIR VALUE IN CURRENT PRACTICE

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	52	56	45	57	56	44	44	51
Feel very strongly	21	25	16	26	24	15	16	16
Feel somewhat strongly	31	32	29	31	32	29	28	35
Feel not very strongly	22	21	24	20	22	29	23	21
Believe no change is needed	25	21	30	21	22	26	32	28

Here the critical result is that while 52% feel that such expansion should take place, no more than 21% feel very strongly about it. Further, a large minority feel that no change is needed. There is only marginal support for expansion of fair value accounting for productive assets.

The final question related to footnote disclosures of fair value information for productive assets:

Q2c. ADDITIONAL DISCLOSURES OF FAIR VALUES OF PRODUCTIVE ASSETS

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	62	62	62	62	63	51	64	65
Feel very strongly	23	24	22	24	23	16	23	24
Feel somewhat strongly	39	39	40	38	40	34	41	41
Feel not very strongly	20	20	19	20	21	30	17	14
Believe no change is needed	17	16	19	16	15	18	18	21

There is more support for disclosure of fair values of productive assets than for fair value accounting for those assets. However, the 23% who feel very strongly about it falls a bit short of the critical mark, which would indicate strong support for change.

Display in Financial Statements

The study defined "display" as covering classification, layout, and level of detail of information on the face of the balance sheet, income statement and cash flow statement or in related footnotes that provide additional information about the details of amounts recognized in financial statements.

The first question deals with the need for improvements in the display of information in the balance sheet, income statement, and cash flow statement:

Q3. NEED FOR IMPROVEMENT IN THE DISPLAY OF INFORMATION IN THE BALANCE SHEET, INCOME STATEMENT OR CASH FLOW STATEMENT

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	48	50	45	54	46	56	43	40
Feel very strongly	17	18	15	19	16	16	15	14
Feel somewhat strongly	32	33	30	35	30	40	28	26
Feel not very strongly	28	27	30	25	28	34	27	36
Believe no change is needed	23	22	25	19	25	9	30	24

Here, for the first time, less than a majority feel strongly about improving the display of information in the balance sheet, income statement, or cash flow statement, although majorities of equity and debt analysts want improvement.

Yet, users warmed to improvement in display when asked more detailed questions:

Q.14 DISPLAY OF INFORMATION IN FINANCIAL STATEMENTS

	Total Agree %	Agree Strongly: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr %
Companies should do a better job of separately identifying the effects of unusual, infrequent, and nonrecurring transactions or events on the face of the financial statements or in related footnote disclosures.	89	48	45	52	51	36	50	54	57
One method of separately identifying the effects of unusual, infrequent, and nonrecurring transactions and events would be to distinguish between core and noncore earnings on the face of the income statement. Core earnings result from continuing, recurring, and usual operating activities. Conversely, the non-core category includes the effects of nonrecurring, unusual, and infrequent transactions or events, discontinued operations, and gains and losses from non-core assets and liabilities. How do you feel about separately displaying core and noncore earnings on the face of the income statement?	87	45	44	47	47	41	39	48	49
Companies should separately identify on the balance sheet and cash-flow statement those assets, liabilities, and cash flows that result from nonrecurring, unusual, and infrequent transactions or events.	90	50	51	50	54	47	47	52	49
In general, companies should increase the amount of detail displayed on the face of the of the financial statements.	80	27	29	25	31	26	31	24	26
In general, companies should provide more detail of items included in the other category, such as other income and expense, and other deferred charged and credits, using a lower materiality threshold than is currently used.	79	31	33	27	37	27	31	27	26
Companies should provide more detail about the nature of and changes in valuation reserves, such as reserves for receivables and inventories.	85	31	31	31	36	24	36	30	29
Companies should disclose past-due receivables, or an aging of receivables.	86	34	30	42	30	30	39	46	31
Companies should disclose slow-moving inventory or an aging of inventory.	85	32	29	39	28	30	33	42	31
Nearly all companies report cash flows from operations using the indirect method. That method starts with net income and adds back noncash charges and credits to arrive at cash from operations. An optional method, which is rarely used, is called the direct method.									
That method starts with cash from revenues and subtracts cash paid for expenses to arrive at the same cash from operations. Users find acceptable the information provided by the indirect method, and do not need a change to the direct method.	71	28	27	30	31	21	39	29	26

In these key answers to specific questions about display of financial statements, it is evident that these respondents come down strongly on need to improve display of information, with the single exception of the use of the direct method for presenting cash flows from operations. Not only do all pass muster in terms of delivering solid majorities in favor of each of the specifics asked about, but they are all above the 25% mark in terms of being agreed to strongly.

Thus, real emphasis is placed on the following:

-- A better job must be done of separately identifying the effects of unusual, infrequent, and nonrecurring transactions or events in the financial statements.

-- And they want such identification to clearly demarcate between core and noncore earnings on the face of the statement.

-- They want separately identified on the balance sheet and cash-flow statement those assets, liabilities, and cash flows stemming from nonrecurring, unusual, and infrequent transactions or events.

-- Basically, they want more detail displayed on the face of financial statements.

-- They believe this detail should include more detail of "other" categories, such as income and expense, and other deferred charged and credits, using a lower materiality threshold than is now used.

-- They want more detail about the nature of and change in valuation reserves, such as reserves for receivables and inventories.

-- They want companies to disclose past-due receivables, or an aging of receivables.

-- They want a disclosure of slow-moving inventory or an aging of inventory.

-- However, they do not opt for adoption of the direct method in reporting cash flows from operations. They are satisfied to continue to use the indirect method.

Why the disparity between the users' initial coolness toward improvement in display of information and their later interest in such improvement? Perhaps the survey initially confused the users with the term display. However, later questions, with specific examples of the types of improvements being considered could have clarified the issue and thereby received a stronger response. That response pattern is consistent with responses to questions on other issues, where users' reactions to broad issues were initially only lukewarm until they were brought to life with specific examples in later questions. This pattern occurred in a number of the 12 areas tested.

Improvement in Footnote Disclosures About Unconsolidated Entities

Decisive majorities feel strongly about footnote disclosure of financial information about unconsolidated entities. These were defined as entities including 50% or less owned investments by one company in another company, partnership, or joint venture:

Q4.IMPROVEMENT IN FOOTNOTE DISCLOSURES ABOUT UNCONSOLIDATED ENTITIES

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	82	81	83	83	79	85	83	83
Feel very strongly	44	46	40	49	43	44	40	38
Feel somewhat strongly	38	35	43	34	36	41	42	45
Feel not very strongly	11	12	9	10	14	9	9	10
Believe no change is needed	6	5	7	5	6	6	7	7

Accounting for and Recognition of Intangible Assets

First, respondents on both the investor and creditor sides were asked about recognition of internally generated intangible assets, such as patents, trademarks, and goodwill. The majority did not support this proposal, as the next table indicates:

Q5.FINANCIAL STATEMENT RECOGNITION OF INTERNALLY GENERATED INTANGIBLE ASSETS

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	43	45	38	48	42	37	39	38
Feel very strongly	17	18	15	21	15	14	14	20
Feel somewhat strongly	26	27	24	28	27	23	26	18
Feel not very strongly	25	23	27	23	24	25	28	25
Believe no change is needed	31	30	34	28	32	38	33	35

With no more than more than 43% who feel strongly about such recognition of internally generated intangible assets in financial statements, it is evident this area does not have a strong draw -- at least initially. A substantial 31% see no need for change in this respect.

However, another question asked about the need to improve disclosure about intangible assets. This produced an entirely different and far more activated response:

Q5b.IMPROVEMENTS IN DISCLOSURE ABOUT THE IDENTITY, SOURCE, AND LIFE OF A COMPANY'S PURCHASED OR INTERNALLY GENERATED INTANGIBLE ASSETS

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	70	70	68	72	69	69	68	68
Feel very strongly	32	33	31	39	26	33	31	29
el somewhat strongly	38	38	37	33	43	36	37	39
Feel not very strongly	17	16	18	15	18	17	18	16
Believe no change is needed	13	12	13	13	12	14	13	14

Here a powerful mandate is manifested, with fully 70% saying that more disclosure about such intangible assets is important.

Alternative Accounting Procedures

Alternative accounting procedures involve alternative accounting methods that can be used to report a similar class of transaction or event. Some alternative procedures results solely from management's choice from among accepted options. Examples include inventory accounting methods for which both FIFO or LIFO are permitted, and, methods of computing depreciation, including straight-line and accelerated methods. Other alternative procedures result from the degree to which a transaction or event meets specified criteria. Examples of those procedures are the capital versus operating treatment of leasing transactions, and the purchase versus pooling methods of accounting for business combinations.

The users were asked about the desirability of narrowing the number of alternative accounting procedures so that companies generally would have only one method of accounting for a transaction or event:

Q6. NARROWING THE NUMBER OF ALTERNATIVE ACCOUNTING PROCEDURES SO COMPANIES GENERALLY WOULD HAVE ONLY ONE METHOD OF ACCOUNTING FOR A TRANSACTION OR EVENT

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	67	65	70	62	69	67	69	75
Feel very strongly	35	35	37	34	37	36	37	36
Feel somewhat strongly	31	30	33	28	33	31	32	39
Feel not very strongly	17	18	17	21	15	22	17	11
Believe no change is needed	14	15	12	15	15	10	13	12

These results indicate that narrowing of alternative accounting methods to one method of accounting for a particular transaction or event has real appeal, with 67% overall saying they feel strongly about such a change and 35% feeling very strongly about it. All groups share this view.

Then, an additional series of questions was asked later in the survey:

Q15. USE OF ALTERNATIVE ACCOUNTING PROCEDURES

		Agree Strongly							
	Total Agree	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%	%
Accounting standards should not be changed to specify a single accounting method in areas where alternative methods could be equally appropriate, such as depreciation methods, or methods of accounting for inventories.	73	22	22	21	27	16	17	26	9
Standards currently require that some business combinations be accounted for as purchases, while others be accounted for as poolings of interests. Standards should not be changed to require that all business combinations be accounted for under a single method.	66	27	30	23	36	21	28	22	23
Standards currently require that some leasing transactions be accounted for as operating leases, and others be accounted for as capital leases. Standards should be changed so that all uncancellable leases with terms of more than one year should be accounted for as capitalized leases.	66	24	24	24	26	21	31	20	34

Here, users send contradictory signals about use of alternative accounting procedures. On the one hand, they support the concept of narrowing the number of alternative accounting procedures, with 67% feeling strongly about it, and 35% very strongly about it. However, they reverse themselves when it comes to specific cases. For example, 73% agree that accounting standards should not be changed to specify a single accounting method in areas where alternative accounting methods could be equally appropriate, such as depreciation methods, or methods of accounting for inventories. Another example is the 66% who agreed that standards should not be changed to require that all business combinations be accounted for under a single method.

The users also support capitalizing all leases, although support was not overwhelming. A majority of 66% agree that leases should be capitalized, but no more than 24% agree strongly.

Measurement Uncertainties

Inherent in measuring many assets and liabilities under accrual accounting is the need to make estimates of transactions and circumstances that have not been completed. Such estimates involve assumptions and judgments made in good faith but subject to the uncertainty of the future. Examples would include measurement of the obsolete portion of inventory, the uncollectible portion of high-risk receivables, the current amount recoverable from discontinued operations, the defective portion of product sold in the measurement of a warranty liability, and the liability that will result from environmental damage.

First, respondents were asked how strongly they felt about improvement in disclosures of measurement uncertainties:

Q7.IMPROVEMENTS IN REPORTING OF MEASUREMENT UNCERTAINTIES

	Total	Investors	Creditors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	59	59	60	58	60	61	58	67
Feel very strongly	23	23	22	23	24	23	22	21
Feel somewhat strongly	36	35	38	34	36	38	35	47
Feel not very strongly	17	17	15	18	16	17	16	12
Believe no change is needed	13	14	13	13	15	11	14	11

A majority of 59% feels strongly that improvement in the reporting of measurement uncertainties should take place. A marginal 23% feel very strongly about it.

Clearly, the users had not given serious enough thought to this area, because later on, when asked about specific changes that might be made, they expressed deep desire for improvement:

Q16. CHANGES TO ACCOUNT FOR MEASUREMENT UNCERTAINTIES

	Total Agree %	Agree Strongly: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
16a. For each type of asset and liability that is particularly sensitive to measurement uncertainties, the notes to the financial statements should (1) disclose the significant uncertain conditions underlying the measurement, (2) discuss how amounts were derived, and (3) explain the basis of estimates, assumptions, and judgments used.	89	42	40	47	42	37	42	43	66
b. The notes to the financial statements should include a statement that uncertainties are inherent in measuring those items because estimates, assumptions, and judgment are necessary in determining their reported amounts.	80	31	30	31	32	27	28	30	40

In these answers, the need to improve disclosures about measurement uncertainties emerges:

– 89% of users agree and 42% strongly agree that the notes to the financial statements should disclose the significant uncertain conditions underlying the measurement, discuss how amounts were derived, and explain the basis of estimates, assumptions, and judgments used for each type of asset and liability that is particularly sensitive to measurement uncertainties,

– 80% of the users agree and 31% agree strongly that the notes to the financial statements should include a statement that uncertainties are inherent in measuring those items because estimates, assumptions, and judgment are necessary in determining their reported amounts.

Financial Instruments and Off-balance Sheet Financing

In recent years, there has been an explosion in innovative financial instruments and off-balance sheet financing arrangements. Many of the instruments and arrangements raise fundamental accounting questions, including these:

– When should financial instruments be recognized on the balance sheet?

– How should financial instruments be measured?

– When should financial assets be considered sold and financial liabilities be considered settled?

-- How should financial instruments that consist of both liability and equity elements be treated by issuers of those financial instruments?

-- When is it appropriate to offset financial assets and liabilities in the balance sheet?

-- What special accounting, if any, is appropriate for financial instruments that hedge risk?

The first question in this area asked about improving the accounting for financial instruments and off-balance sheet financial arrangements:

Q8a. IMPROVING THE ACCOUNTING FOR FINANCIAL INSTRUMENTS AND OFF-BALANCE SHEET FINANCIAL ARRANGEMENTS

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	86	87	83	88	86	86	81	84
Feel very strongly	53	54	50	55	53	59	44	60
Feel somewhat strongly	33	33	33	33	33	28	37	24
Feel not very strongly	8	8	9	6	10	9	9	9
Believe no change is needed	5	4	7	5	4	5	9	5

The introduction of off-balance sheet financial arrangements triggers a sizable demand for improvement in accounting for these arrangements, cited by a high 86% overall and 53% who feel very strongly about it. Obviously, this is a high priority area.

There was a veritable explosion of demand for change when they were asked about changes in disclosures related to innovative financial accounting and off-balance sheet financing arrangements. These disclosures would describe the innovative financial instruments used and the off-balance sheet arrangements entered into, would describe the business reasons for using those instruments and entering into those arrangements, and would discuss the risks involved with those instruments and arrangements.

Here are the results:

Q8b. CHANGES IN DISCLOSURES RELATED TO FINANCIAL INSTRUMENTS AND OFF-BALANCE SHEET ARRANGEMENTS

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	90	91	89	91	92	89	89	90
Feel very strongly	60	61	59	63	58	59	57	66
Feel somewhat strongly	30	31	30	27	35	30	32	24
Feel not very strongly	7	6	9	6	6	9	9	9
Believe no change is needed	2	2	2	3	2	2	2	1

Across-the-board, sentiment is virtually unanimous in feeling that real change is needed in the reporting of innovative financial instruments and off-balance sheet arrangements. Clearly, there are concerns that what is now currently not reported or disclosed could contain information material to making investment or credit decisions,

Interim Reporting

The next area asked about was that of interim reporting, which includes all communications in external reporting other than those relating to annual periods. It includes quarterly reports on Form 10-Q, periodic reports on Form 8-K, and press releases. Issues also involve frequency of reporting, the need for condensed or uncondensed financial statements and footnotes, disclosure of disaggregated information, and the desirability of fiscal year-to-date or trailing 12 months information about income and cash flows.

The users were asked about improvements in the timeliness or content of interim reporting:

Q9. IMPROVEMENTS IN TIMELINESS OR CONTENT OF INTERIM REPORTING

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	46	48	41	54	42	45	41	37
Feel very strongly	18	21	13	27	15	18	14	8
Feel somewhat strongly	27	27	28	27	27	26	27	29
Feel not very strongly	30	27	33	24	31	31	34	34
Believe no change is needed	24	23	25	20	26	21	24	29

Once again, in their initial reaction, the results are bland and no more than 46% report wanting improvements in the timeliness or content of interim reporting.

However, as happened in a number of instances, more detailed probing elicited a stronger response. In addition, eight specific questions were asked about interim reporting. In the case of four of the eight, the outcome did produce a consensus for important changes. On the other four, however, a rather low priority prevailed:

Q.17. CHANGES IN INTERIM REPORTING OF FINANCIAL STATEMENTS

	Total Agree %	Agree Strongly: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
External reporting should take place as soon as possible following a reportable event, but at least quarterly.	95	69	68	71	71	64	64	75	66
If companies report separately on the fourth quarter, that reporting should focus on fourth quarter income and cash flow, and management's analysis of that income and cash flow, including significant fourth quarter adjustments.	92	46	47	43	51	42	58	40	40
For critical transactions and events, such as business combinations, lawsuits, etc. information should be reported within a few days of the transaction or event.	87	60	65	52	65	64	64	52	43
Unlike current practice, companies should report complete fourth quarter information, even if that information is released concurrent with annual reporting.	82	43	47	37	48	44	53	33	37
Current reporting on SEC Form 10-Q permits condensed complete financial statements. Instead, interim information should consist of financial statements in the same level of detail as in annual statements.	60	22	23	20	24	20	36	15	20
Interim reporting should include quarterly cash flow statements rather than the year-to-date cash flow statements as currently reported in SEC Form 10-Q reports.	59	22	25	16	27	24	36	10	17
SEC quarterly reports on Form 10-Q currently report both quarterly and year-to-date income statements. Rolling-12 month income statements should be added to the information in those quarterly reports.	56	19	20	15	20	21	33	10	11
If rolling-12 month income statements are added to SEC quarterly reports, it would be acceptable to delete the year-to-date income statements currently provided.	37	9	12	6	12	12	3	6	6

Four changes in interim reporting come up strong and clear from the responses of both investors and creditors:

— A nearly unanimous 95% agree and 69% agree strongly that external reporting should take place as soon as possible following a reportable event, but at least quarterly.

– Another high 92% agree and 46% agree strongly that if companies report separately on the fourth quarter, that reporting should focus on fourth quarter income and cash flow, and management's analysis of that income and cash flow, including significant fourth quarter adjustments.

– 87% agree and 60% agree strongly that for critical transactions and events, such as business combinations, lawsuits, etc., information should be reported within a few days of the transaction or event.

– 82% also agree and 43% agree strongly that unlike current practice, companies should report complete fourth quarter information, even if that information is released concurrent with annual reporting.

Nonfinancial Business Information

Nonfinancial business information includes all types of information in external reporting except financial statements and related footnote disclosures. It includes information such as these relating to both the company and each of its business segments:

– Mission, broad objectives, and strategy to achieve them.

– Scope and description of the business and its properties.

– Description of the segment's industry structure, such as information about the ability of new companies to enter the industry, the ability to substitute products or services to displace the industry's, the relative bargaining power of resource providers including employees, the bargaining power of customers, and intensity of competition in the industry.

– Identity and description of directors, management, compensation, major shareholders, and related-party transactions and relationships.

– Key nonfinancial statistics that management uses to run the business in areas as market penetration and quality, costs and productivity, innovation, timeliness to perform key activities, amount and quality of key resources, and resource provider satisfaction.

– Management's analysis of key relationships in both financial and nonfinancial data and reasons for changes in that data during recent periods, including the identity and past effect of key trends.

The survey asked how strongly investors and creditors feel about expanding disclosures of nonfinancial information such as that described above:

Q10a.EXPANSION OF DISCLOSURES OF NONFINANCIAL INFORMATION

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	50	51	48	57	43	56	45	47
Feel very strongly	16	18	13	22	13	14	14	11
Feel somewhat strongly	33	33	35	35	30	43	32	36
Feel not very strongly	31	30	33	26	34	29	33	37
Believe no change is needed	18	18	18	15	22	14	20	16

Interest and intensity over expanding reporting of nonfinancial information was not of a major magnitude overall, although it should be noted that a majority of equity analysts and credit analysts both feel strongly about it.

Importantly, however, when more detailed questions were asked later, the information needs in this area increased dramatically.

Those who said either they did not feel strongly about it or believe no change is needed were asked if the reason was because they now have adequate sources for that information, such as from discussions with management:

Q10b.ADEQUACY OF SOURCES FOR NONFINANCIAL INFORMATION

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Have adequate sources for that information	77	75	81	72	78	71	84	78
Do not feel that way	18	21	14	22	19	16	12	18
Not sure	5	4	5	6	3	13	4	4

Seventy-seven percent do not feel strongly about nonfinancial information because they have adequate sources for that information.

But appreciation of the usefulness of nonfinancial information emerged later in the survey when investors and creditors were asked about this area in depth.

The sample was asked about the usefulness of specific types of nonfinancial business information, regardless of whether the information is now part of external reporting. Specifically, the sample was asked whether each type of information is essential, helpful, merely interesting, or not useful in their work:

18.USEFULNESS OF NONFINANCIAL INFORMATION

Type of Information	Total Essential-Helpful %	Essential Information: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
Scope and description of the business and related properties held.	87	34	37	28	37	38	22	32	23
Management's discussion and analysis of key relationships in both financial and nonfinancial data and reasons for changes in data during recent periods, including the identity and past effect of key trends.	87	32	33	30	32	34	33	31	23
The identity and description of transactions and relationships among related parties.	82	41	41	43	43	38	28	50	31
Description of the company's industry structure, such as information about (a) the ability of new companies to enter the industry, (b) the ability of substitute products or services to displace those produced by the company, (c) the relative bargaining power of resource providers, including employees, (d) the bargaining power of customers, and (e) the intensity of competition in the industry.	80	32	36	25	35	39	28	25	23
The identity and description of management incentive plans, including formulas used, if any.	80	25	30	16	29	32	8	16	26
Key nonfinancial statistics that management uses to run the business, in areas such as (1) market penetration and quality, (2) costs and productivity, (3) innovation, (4) timeliness to perform key activities, (5) amount and quality of key resources, and (6) resource provider satisfaction.	80	26	30	19	30	31	36	14	17
The identity and background of directors and management.	70	24	24	25	25	21	17	26	29
The identity of major shareholders.	68	19	23	14	28	16	14	14	11
Mission, broad objectives, and strategy to achieve the broad objectives.	66	16	19	11	17	21	19	10	9

As has been the case in many parts of this survey, the more investors and creditors gave thought to the usefulness of non-financial information, the more selective and also the more committed they became to advocating specific changes:

– 87% found that the scope and description of the business and related properties held was essential or helpful, while 34% view these as essential.

– While 87% feel that management's discussion and analysis of key relationships in both financial and nonfinancial data and reasons for changes in data during recent periods, including the identity of past effect of key trends is both essential and helpful, 32% feel this information is essential.

– 82% feel that the identity and description of transactions and relationships among related parties is helpful and essential, a high 41% feel it is essential -- indeed, indispensable to them in their work.

– 80% feel that it is either helpful or essential to have a description of the company's industry structure, such as information about the ability of new companies to enter the industry, the ability of substitute products or services to displace those produced by the company, the relative bargaining power of resource providers such as employees, the bargaining power of customers, and the intensity of competition in the industry. A substantial 32% feel such information is essential.

– 80% also feel that it is helpful or essential for them in their work to obtain the identity and description of management incentive plans, including formulas used, if any. And 25% feel that disclosure of such plans is essential to them in their work.

– 80% also feel it is helpful or essential with 26% saying it is essential for them to have key nonfinancial statistics that management uses to run the business, in areas such as market penetration and quality, costs and productivity, innovation, timeliness to perform key activities, amount and quality of key resources, and resource provider satisfaction.

Forward-Looking Information

External reporting currently provides information about the past and the present. It does not focus on forward-looking information. This kind of information would include matters such as the identity and future effect of key trends affecting the business, opportunities and risks, factors or conclusions internal to the company that are critical to achieving its objectives, management's major plans for future activities that will impact future cash flows, and comparison of actual business performance to previously disclosed forward-looking information. However, forward-looking information does not include projected or forecasted financial statements.

The sample of investors and creditors was asked if they wanted an expansion of reporting of forward-looking information:

Q11a.EXPANSION OF REPORTING OF FORWARD-LOOKING INFORMATION

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	44	44	45	45	42	40	48	40
Feel very strongly	16	16	15	19	13	17	14	14
Feel somewhat strongly	28	27	30	26	28	23	34	26
Feel not very strongly	28	27	30	26	28	29	30	33
Believe no change is needed	26	28	23	27	28	30	20	26

In this case, no more than 44% of the investors and creditors express a strong feeling that they want more information about forward-looking information.

When this question was followed by another that asked those who did not feel strongly or believed that no changes are needed if this was because they already have adequate sources of information other than external reporting, they responded as follows:

Q11b.ADEQUACY OF SOURCES OF INFORMATION FOR FORWARD-LOOKING INFORMATION

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Have adequate sources of information	60	58	63	55	62	56	69	53
Do not feel that way	33	34	31	36	32	35	27	40
Not sure	7	8	6	9	6	9	4	7

Most users are also not interested in receiving forecasts or projected financial statements from the management of companies:

Q11c.MANAGEMENT PROJECTIONS OR FORECASTS OF PERFORMANCE

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Total Strongly	36	34	41	34	33	32	45	35
Feel very strongly	12	11	13	13	9	9	17	8
Feel somewhat strongly	24	23	27	22	24	23	28	27
Feel not very strongly	27	28	26	29	27	26	25	28
Believe no change is needed	36	37	33	37	38	38	30	36

Only 36% of the respondents believe strongly that management should provide projections or forecasts and excluding credit grantors would result in an even lower number. In contrast, another 36% say there is no need for such projections or forecasts from management. Reasons for that view could be : the belief that management forecasts are inherently unreliable, and that analysts believe it is their responsibility to prepare forecasts. Later in the survey, investors and creditors were asked how useful certain types of forward-looking information is in their work:

Q19. USEFULNESS OF FORWARD-LOOKING INFORMATION

Type of Information	Essential %	Helpful %	Merely Interesting %	Not Useful %
The identity and future effect of trends affecting the business.				
Total	31	56	10	3
Investors	33	56	8	3
Creditors	29	56	13	2
Equity Analysts	30	57	9	5
Equity Portfolio Managers	36	55	7	1
Debt Analysts	31	50	17	3
Debt Portfolio Managers	23	60	17	--
Credit Grantors	30	57	11	2
Opportunities and risks				
Total	28	54	14	3
Investors	28	55	15	2
Creditors	28	54	11	6
Equity Analysts	26	57	15	2
Equity Portfolio Managers	30	53	16	1
Debt Analysts	25	44	22	9
Debt Portfolio Managers	23	57	11	6
Credit Grantors	31	56	8	3
Factors or conditions internal to the company that are critical to achieving its objectives				
Total	50	41	7	2
Investors	52	40	7	1
Creditors	46	44	8	2
Equity Analysts	52	38	7	3
Equity Portfolio Managers	53	42	5	--
Debt Analysts	44	36	17	3
Debt Portfolio Managers	54	34	11	--
Credit Grantors	44	48	4	2
Management's major plans for future activities that will impact future cash flows.				
Total	57	38	5	—
Investors	57	38	5	—
Creditors	57	37	6	—
Equity Analysts	54	39	6	1
Equity Portfolio Managers	61	36	3	--
Debt Analysts	44	44	12	—
Debt Portfolio Managers	51	43	3	3
Credit Grantors	63	33	3	1
Comparison of actual business performance to previously disclosed forward-looking information.				
Total	21	57	17	5
Investors	21	58	16	5
Creditors	21	56	20	3
Equity Analysts	16	60	17	4
Equity Portfolio Managers	28	54	14	4
Debt Analysts	19	50	28	3
Debt Portfolio Managers	14	57	26	3
Credit Grantors	23	57	17	1

Users find that certain types of forward-looking information is essential or at least helpful. In particular:

– A substantial 95% feel that management's major plans for future activities that will impact future cash flows is helpful or essential information to have. Significantly, a high 57% feel it is essential to have.

– Similarly, 91% say that it would be helpful or essential for them to have forward-looking information on the factors or conditions internal to the company that are critical to achieving its objectives, with fully 50% who say such information is essential to their work.

– Finally, 87% feel that it is helpful or essential for them to have the identity and future effect of trends affecting the business, with 31% who feel such information is essential.

Why do users, on the one hand, not support expanding forward-looking information in external reporting, while, on the other hand, indicate that forward-looking information is so important to them in their work? There are at least three possibilities. First, the users could believe that preparing forward-looking information is their job, rather than management's job. Second, users could be satisfied with their current sources for forward-looking information, such as discussions with management, and do not believe that external reporting offers a better delivery vehicle for that information. Third, the users could have ranked forward-looking information relatively low in question 11(a) because they confused the term with projected financial statements which they do not want part of external reporting, or because they were uncertain about the meaning of the term. Later, when provided with specific descriptions, they warmed to the need for forward-looking information.

Sorting Out Priorities Among the 12 Key Areas Under Consideration

After initial exposure to each of the 12 areas, the respondents were then asked to rank the relative usefulness of possible improvements in each:

Q12. RELATIVE USEFULNESS OF EACH KEY POTENTIAL AREA OF IMPROVEMENT

Area for Improvement	Relative Usefulness: HIGH							
	Total %	Inves-tors %	Credi-tors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port Mgr. %
Accounting for and disclosures about financial instruments and off-balance-sheet financing arrangements	60	59	61	58	60	62	58	68
Disaggregated information	52	56	47	61	50	62	41	50
Disclosure of financial information about unconsolidated entities	51	49	54	51	47	55	54	50
Fair value information in financial statements or in related footnote disclosures	45	46	45	44	48	40	45	47
Narrowing the scope of alternative accounting procedures	33	33	33	32	34	28	31	42
Display of information in financial statements	32	34	28	38	28	26	29	28
Accounting and disclosure for intangible assets, including goodwill	28	30	23	35	26	26	22	24
Interim reporting	26	28	25	35	19	23	29	13
Forward-looking information	26	26	26	29	23	23	30	18
Projected or forecasted financial statements	25	22	28	23	20	17	36	17
Nonfinancial business information about the past and the present	23	25	20	28	22	22	21	14
Disclosures about measurement uncertainties	23	22	22	24	21	26	21	22

Because of the wording of this question, its usefulness is limited to ranking areas for potential improvement. That is, it indicates which ones are of the highest priority.

Auditor Involvement in External Reporting

Today, the auditor's report is presented in a three paragraph format and states that the financial statements present fairly in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.

The survey asked users about two possible additions to the report: 1.) the extent of auditor involvement with external reporting, including reporting on disclosures outside the financial statements, and 2.) whether auditors should provide additional analytical commentary in areas that may assist users. Such a commentary would provide the auditor's own views on significant matters underlying financial statements, such as estimates, assumptions and judgments, accounting principles, opportunities and risks, internal controls, and other areas. The first series of questions asked the sample dealt with auditor involvement with external reporting:

23. AUDITOR INVOLVEMENT WITH EXTERNAL REPORTING

	Total Agree	Agree Strongly: Total	Investors	Creditors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%	%
Users need audited financial information because it provides independent assurance of the reliability of amounts reported and disclosed in financial statements not otherwise verifiable by third-party users.	95	68	67	68	69	66	69	66	74
The way it is now, auditors' reports use a standardized format that varies only in limited ways for unusual situations. Do you agree or disagree that the current standardized format of auditors' reports gives you what you need to know from auditors?	67	19	18	22	19	16	16	25	21
Auditors' reports could cover any forward-looking information disclosed by management. This could include prospects for changes, identifying future key trends and their effects, opportunities and risks, factors or conditions critical to achieving corporate objectives, and management plans that could affect earnings and cash flows. Do you agree or disagree that the auditor's report should provide some level of assurance about management disclosures of forward-looking information?	57	21	22	21	21	22	8	28	16
Auditors' reports could also cover non-financial business information disclosed by management. This could involve reporting on corporate objectives and strategies, and descriptions of industry structures and relationships. Do you agree or disagree that the auditors' report should provide some level of assurance on non-financial business information disclosed by management?	52	11	11	13	13	9	6	16	9

A strong 95% of respondents agree (and 68% agree strongly) that the audited financial information is critical because it provides independent assurance of reliability not otherwise verifiable by third-party users. At the same time, only 67% agree that the auditors' standard report gives them what they need to know from auditors. Investors and creditors may want something more from auditors, but it doesn't seem to be assurance on either forward-looking information or nonfinancial business information

The second area explored deals with auditor's reports being expanded to provide commentary analyzing a number of issues involving corporate disclosures. Here are the questions asked:

Q24. AUDITOR INVOLVEMENT IN PROVIDING COMMENTARY ON ISSUES OF CORPORATE DISCLOSURE

	Total Agree %	Agree Strongly: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
One area of possible auditor commentary would be measurement uncertainties. If corporate disclosures were expanded to include significant uncertain conditions underlying specific amounts in financial statements, how amounts were derived and what estimates, assumptions, and judgments are based on, auditors could provide separate commentary on such matters. Do you agree or disagree that such separate commentary should be included in the auditors' report?	68	23	23	21	22	24	27	20	16
Corporate financial statement disclosures now include descriptions of certain accounting principles underlying the financial statements. The auditors' report could include commentary analyzing these accounting principles in relation to other alternative accounting methods, particularly accounting principles used by other corporations in the same industry. Would you agree or disagree that such commentary should be in the auditors' report?	80	31	32	28	32	33	33	25	32
Corporate disclosures could be expanded beyond present limits to reveal opportunities and risks management believes can expose the corporation to changes in future earnings and cash flow. Do you agree or disagree that the auditors' report should include a separate commentary on such disclosures?	56	16	18	14	18	17	8	15	14

Here we find a some initial support for an auditor commentary as part of the auditor's report. Overall, 80% agree with 31% agreeing strongly that it would be appropriate for an auditor's report to contain commentary on accounting principles used by other companies in the same industry.

The final area of auditor commentary deals with the problems of such commentary matching or diverging from management's views:

Q25,26. USE OF AUDITOR COMMENTARY IN RELATION TO MANAGEMENT VIEWS

	Total Agree	Agree Strongly: Total	Investors	Creditors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%	%
Suppose the auditors' commentary analysis is essentially the same as that of management. Do you agree or disagree that it still should be part of the auditor's report?	71	31	32	30	35	29	35	28	28
And what if the auditors' commentary is significantly different from management's views, even though both might have real merit. Do you agree or disagree that having the auditors' views would help you by providing distinct and independent views in addition to the reasonable views of management?	80	52	53	49	54	52	51	48	51
Matters such as accounting estimates, opportunities, and risks may turn out to have consequence in the future quite different from those discussed in an auditor's commentary. Do you agree or disagree that, if that happened, the auditor's independence in auditing future financial statements would <u>not</u> be affected?	52	14	12	16	15	10	14	19	9

Expanding the auditors' report to include commentary could increase the costs of audits. Very roughly, what is the maximum cost that companies should incur to provide users with the benefits of auditor commentary in auditors' reports? Please express your response in terms of the percentage of the audit fee that you perceive is currently charged. Should the maximum cost be zero, 10 percent, 25 percent, 50 percent, or more than 50 percent?

	Total
	%
Zero	13
10 percent	42
25 percent	26
50 percent	3
More than 50 percent	4
Not sure	12

The case for auditor commentary comes to life dramatically when it is juxtaposed with management's views. The results have already pointed up the indispensability of the audit to creditors and investors alike as the one source that can verify the reliability of amounts reported and disclosed in financial statements.

But, when each person interviewed was confronted with the prospect on an auditor's commentary as a check on the views and judgment of management, the response was decisive:

-- A sizable 71% found themselves in agreement with the view that an auditor's commentary would still be desirable even if that commentary was essentially the same as that of management. And 31% agreed strongly with that proposition.

-- But the real test came when they were asked if the auditor's commentary is significantly different from management's views, even though both might have real merit. Then an overwhelming 80% agreed that such a commentary was desirable "by providing distinct and independent views in addition to the reasonable views of management." And, most significantly, 52% felt strongly about this.

Finally, users were asked about the maximum cost as a percentage of the audit fee. that companies should incur, to provide users with the benefits of auditor commentary. A majority responded that the maximum cost should be 10% of greater, with 42% of the users responding 10%, and 26% of the users responding 25%.

Mitigating the Cost of Improving External Reporting

The Special Committee has pointed out that if many of the improvements that it has in mind were adopted, external reporting could increase in cost. These costs would include the costs of accumulating, auditing, and transmitting the information; costs resulting from disclosing information to competitors and suppliers; and costs resulting from litigation.

The survey asked users for their views on five policies that would mitigate the cost (and potentially the benefits of improvements in external reporting:

Q27. POLICIES THAT MITIGATE THE COSTS OF IMPROVING EXTERNAL REPORTING

	Total Agree %	Agree Strongly: Total %	Investors %	Equity Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
Management should not be required to report information about other companies because, generally, management is not the best source for that information. Rather, the disclosures should emphasize how the environment impacts the company.	86	52	53	49	56	50	53	51	42
Management should not be required to provide projected financial statements. Rather, management should provide information that helps investors and creditors project for themselves the company's financial future.	74	50	58	38	60	55	41	30	56
Generally, management need only report what <u>nonfinancial business information</u> that it knows. That is, management should be under no obligation to search for nonfinancial business information that it does not have, or need, to manage the business.	77	47	49	43	51	46	47	40	49
Management should not report information that would harm the company's competitive position.	68	41	43	37	39	47	35	38	37
There must be legal safe harbors for management's disclosures of forward-looking information. It is unreasonable to expect management to make candid disclosures of forward-looking information with a high risk of subsequent litigation with the benefit of hindsight.	90	62	62	62	58	66	65	61	61

Investors and creditors recognize that some of their information needs cannot be met due to the costs of providing the information. They support policies that would mitigate the costs of improving external reporting even though some of those policies would reduce the amount of total information disclosed.

– A nearly unanimous 90% agree with 62% who agreeing strongly that there must be legal safe harbors for management's disclosures of forward-looking information. These high majorities endorsed the view that "it is unreasonable to expect management to make candid disclosures of forward-looking information with a high risk of subsequent litigation with the benefit of hindsight."

– A high 86% agree, with 52% in strong agreement, that management should not be required to report information about other companies, because, generally management is not the best source for that information. Rather, they suggest, the disclosures should emphasize how the environment impacts the company.

– A 77% majority agrees, with 47% in strong agreement, that generally, management need only report what nonfinancial business information it actually knows. In other words, management should be under no obligation to search for nonfinancial business information that it does not have, or need, to manage the business.

– Finally, 68% agree, with 41% in strong agreement, that management should not report information that would harm the company's competitive position.

Willingness to Cut Back Disclosures of Less Important Items

Users of external reporting have been criticized for constantly calling for expanded disclosures without being willing to give up any types of existing disclosures that may be less useful. The survey tested user willingness to cut back disclosure of less important items to make room for new changes in external reporting in the following question:

Q20a. WILLINGNESS TO CUT BACK DISCLOSURE OF LESS USEFUL ITEMS TO MAKE ROOM FOR NEW CHANGES IN EXTERNAL REPORTING

	Total	Investors	Creditors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%
Yes, willing	60	61	58	59	64	56	56	66
No, not willing	35	34	36	36	32	39	37	31
Not sure	5	5	6	5	4	5	7	3

The answer is an endorsement to cut back less important items in current financial reports to allow for the new changes.

Finally, the credibility of external reporting was tested, with mixed results:

Q21. CREDIBILITY OF EXTERNAL REPORTING TODAY

	Total Agree %	Agree Strongly: Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %	Debt Port. Mgr. %
a. Overall, I am satisfied with the credibility of information in external reporting.	87	21	22	20	26	19	18	22	16
b. In general, rather than report neutrally, external reporting tends to portray the company in the best possible light.	78	34	37	28	37	37	35	26	28
c. Companies too often record unnecessary liabilities that could be used to adjust earnings in future periods.	52	13	16	8	16	15	8	9	4
d. Companies too often delay recognizing liabilities and expenses to avoid stepping-up to bad news.	78	28	29	25	27	31	33	24	23
e. Bias in external reporting is generally not a problem because I am usually able to identify any bias that is present.	48	7	8	6	9	8	2	7	5
f. Frequent write-downs of assets and recurring restructuring charges lead me to believe that asset values have been overstated in prior periods, resulting in a loss of confidence in financial reporting.	66	27	31	21	33	29	24	21	19
g. Use of certain financial instruments, off-balance sheet financing arrangements, and other accounting practices serve to make companies appear less risky than they really are.	80	34	34	32	34	34	39	28	39

The responses indicate that:

– While at first glance the 87% who agree generally that "overall, I am satisfied with the credibility of information in external reporting," the fact that no more than 21% can express strong agreement indicates that the general agreement is rather tepid.

– The statement that "bias in external reporting is generally not a problem because I am usually able to identify any bias that is present," meets with no more than 48% agreement and a small 7% who express strong agreement.

By contrast to these rather weak endorsements of the current system of external reporting, several negatives tested produced decisive results:

– A sizable 80% agree, with 34% in strong agreement, that "use of certain financial instruments, off-balance sheet financing arrangements, and other accounting practices serve to make companies appear less risky than they really are."

-- 78% agree, with 34% in strong agreement, that "in general, rather than report neutrally, external reporting tends to portray the company in the best possible light."

-- 78% agree, with 28% in strong agreement, that "companies often delay recognizing liabilities and expenses to avoid stepping-up to bad news."

-- 66% agree, with 27% in strong agreement, that "frequent write-downs of assets and recurring restructuring charges lead me to believe that asset values have been overstated in prior periods, resulting in a loss of confidence in financial reporting."

-- The only negative that did not meet with solid agreement was the 52% who agreed, with only 13% in strong agreement, that "companies too often record unnecessary liabilities that could be used to adjust earnings in future periods."

The Issue of Differential Reporting

The issue of differential reporting arises when some companies prepare external reports following different rules from other companies, depending on the company's industry, its size, whether it is public or private, or some other differentiating factor:

Q22.THE ISSUE OF DIFFERENTIAL REPORTING

	Total Agree	Agree Strongly: Total	Investors	Creditors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor	Debt Port. Mgr.
	%	%	%	%	%	%	%	%	%
Under current rules, companies in certain industries use different accounting methods for certain transactions than companies generally. That practice should continue.	63	16	17	16	19	14	18	17	11
Under current practice, both large and small companies recognize and measure assets and liabilities using the same recognition and measurement rules. That practice should continue.	89	47	46	48	45	47	59	46	44
Under current practice, both public and private companies recognize and measure assets and liabilities using the same recognition and measurement rules. That practice should continue.	88	50	50	51	48	51	55	53	44
In general, both public and private companies should follow the same rules on the form and content of footnote disclosures in financial statements.	89	62	61	61	64	59	65	60	61
Under current practice, the extent to which private companies report information other than information in financial statements, including required disclosures, is the subject of negotiation between the company and its investors and creditors. That practice of negotiation should continue.	63	22	21	24	21	22	41	19	19

The views of investors and creditors on differential reporting are clear:

– Majorities of 63% or better agree with all five of the propositions tested. Two show a lesser intensity of feeling than in the other three. The simple proposition that companies in certain industries using different accounting methods for certain transactions than companies generally should be continued is agreed to by 63% but by only 16% very strongly. And, the proposition that under current practice, the extent to which private companies report information other than information in financial statements, including required disclosures, is the subject of negotiation between the company and its investors and creditors is agreed to by 63%, but by only 22% strongly.

– By contrast, big majorities bordering on the 90% mark agree, with between 47% and 50% in strong agreement, that the practices of both small and large companies recognize and measure assets and liabilities using the same recognition and measurement rules should be continued, as should the same practice among both public and private companies. The same pattern prevails for favoring uniformity in the form and content of footnote disclosures.

The Survey Instrument

LH RESEARCH INC.
1270 AVENUE OF THE AMERICAS
NEW YORK, N.Y. 100120

STUDY 930022A (PHASE I)

Hello, I am ________, calling for LH Research, the national research firm headed by Louis Harris. We have been retained by a Special Committee of the American Institute of Certified Public Accountants (AICPA) to conduct a survey. The Committee was formed in the Spring of 1991 to address increasing concerns about the relevance and usefulness of external reporting by companies to investors and creditors.

For the past two years, this top level group has been learning from people such as yourself -- key leaders in the investment and credit communities -- about your information needs. The Special Committee intends to make recommendations to more closely align external reporting with your needs for information. The Committee's recommendations could impact in important ways what is currently provided by companies in annual reports, 10-K's, 10-Q's, 8-K's, Proxy Statements,
and press releases.

Both the Financial Accounting Standards Board (FASB) and the SEC, are closely following the work of the Special Committee. Their representatives observe its meetings, although neither the FASB nor the SEC have taken any position about its work.

This survey is designed to find out what information and what changes in disclosure and measurement you feel are most needed for your own needs and to provide the best information to help capital markets work most effectively.

We would like to interview you in the next week or so to get your views on this subject that we are sure is vital to your own professional work. Your input will have an important bearing on what is finally recommended. In preparation for that interview, I would like to send you a brief summary explaining the scope of the Special Committee's inquiry and definitions of some of the terms that we will use in the survey.

1. May I send you that summary?

Yes___ (SKIP TO Q.3)
No ___(ASK Q.2)

2. Please reconsider. The purpose of this study is to help people such as yourself. We would appreciate very much your taking the time to read the brief summary we want to send you and then let us ask you some questions about your needs for information that likely will benefit you personally in your work. May I send you the brief summary?

Yes___(ASK Q.3)
No___(TERMINATE)

3. May I fax this summary to you or send it to you in hard copy? (Select One)
FAX? ___ If "yes," Fax to: Area Code:(___) No:______
Hard Copy?: _______________

4. I would also like to confirm some information with you:

Name: ____
Title:____

5. What is your classification (Select one):

	Total %
1. Equity Analyst	29
2. Equity Portfolio Mgr.	29
3. Debt Analyst	29
4. Debt Portfolio Mgr.	7
5. Credit grantor	23
6. Other (specify)________________________________15-	

6. Please describe your industry specialization from this list I will read you. You may select more than one. (READ EACH CHOICE AND CHECK ALL THAT APPLY)

	Total %
a.)No particular industry specialty	54
b.)Manufacturing	7
c.)Consumer products	6
d.)Financial institutions	24
e.)Other services	10
f.)Energy and mining	5
g.)Real estate	4
h.)Start-up high technology	5

7. Address: ____________________
City, State:____________________17-(zip code)________-18
Tel No.:____

8.Do you follow or invest in public or private companies?

	Total %
Public	45
Private	4
Both (vol).	51

9. What percent of your activity in investing or granting credit do you devote to public companies and what percent to private companies?

	Percent
Public companies	(20(___-1
Private companies	___-2

9..Thank you so much for your participation. Now, when might I set a date to ask you some questions about the AICPA Special Committee's work on external reporting?

Call-Back Date: Day and Month__________ Time _______

Thank you once again. I'll talk with you on_____ (date).

LH RESEARCH INC.
1270 AVENUE OF THE AMERICAS
NEW YORK, N.Y. 10020
STUDY 930022A (PHASE II)

Name:______________________________Title:________________________________
Company:___________________________Address:_________________________________
City, State:________________________Tel No.:______________________________
Fax No:____________________________

Hello. I am ____________, calling for LH Research, the national research firm headed by Louis Harris. As we previously arranged with you, I am calling about the survey related to the work of the AICPA Special Committee on Financial Reporting. Thank you for giving us your time.
Did you have a chance to read the brief summary explaining some terms that we will use in the survey? (If not, offer to resend the summary and reschedule the interview for a later date. Do not proceed with the survey if the participant has not read the summary paper). Well, let me get right into the questions I want to ask you. First, I want to ask you in general about several broad areas of disclosure of corporate information. For each area, I will ask you how strongly you feel improvements are needed in that area to enable you to better perform your job. Later in the survey, I will revisit most of these areas, and ask about your reactions to several ideas on how to improve specific disclosures within each area.

1. The first area deals with disaggregated financial information. By disaggregated financial information, we mean financial data about parts of the company rather than consolidated data about the Company as a whole.

How strongly do you feel that improvements are needed in disclosures of disaggregated information? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe that no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	62	53	67	69	66	61	48
Feel very strongly	28	20	34	36	31	18	20
Feel somewhat strongly	33	33	34	33	35	43	28
Feel not very strongly	18	21	16	13	19	22	22
Believe no change is needed	19	25	15	17	13	17	28
Not sure							

The second area of external reporting deals with fair value information in financial statements and related footnote disclosures. In current practices, some assets and liabilities recognized on the balance sheet are measured at historical cost and others are measured at fair value. Further, the footnotes must disclose the fair value of financial instruments, regardless of how those instruments are measured on the balance sheet. We have three questions on this.

2a. The first relates to the measurement of assets and liabilities on the balance sheet. Specifically, it relates to the measurement of those assets and liabilities that are financial instruments. Financial instruments include items such as receivables, investments in securities, payables, and debt. They exclude items such as inventory, property, plant and equipment. How strongly do you feel that the use of fair value accounting should be expanded to include more types of financial instruments than measured at fair value in current practice? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe that no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	52	56	45	68	66	65	68
Feel very strongly	21	25	16	36	31	38	22
Feel somewhat strongly	31	31	29	32	35	27	46
Feel not very strongly	22	21	24	13	19	21	13
Believe no change is needed	25	21	30	17	13	13	17
Not sure							

2b. The second question in this area, also relates to the measurement of assets on the balance sheet. Specifically, it relates to all assets <u>other than</u> financial instruments, such as inventory, property, and intangible assets, and others. I will refer to those as productive assets. How strongly do you feel that the use of fair value accounting should be expanded to include more types of productive assets than measured at fair value in current practice? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe that no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	52	56	45	57	56	44	44
Feel very strongly	21	25	16	26	24	15	16
Feel somewhat strongly	31	32	29	31	32	29	28
Feel not very strongly	22	21	24	20	20	29	23
Believe no change is needed	25	21	30	21	22	26	32
Not sure							

2c. The third question on fair values relates to footnote disclosures of fair value information. Accounting standards already require disclosure of fair value information for financial instruments.
This question relates to disclosure of fair value information for other types of assets -- that is, about productive assets. How strongly do you feel that additional disclosures of fair values of particular productive assets are needed? Do you feel very strongly, feel somewhat strongly, feel not very strongly, or do you believe that no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	62	62	62	62	63	51	64
Feel very strongly	23	24	22	24	23	16	23
Feel somewhat strongly	39	39	40	38	40	34	41
Feel not very strongly	20	20	19	20	21	30	17
Believe no change is needed	17	16	19	16	15	18	18
Not Sure							

3. The next area of external reporting deals with display of information in financial statements. By display I mean classification, layout, and level of detail of information on the face of the balance sheet, income statement and cash flow statement or in the related footnotes that provide additional information about the details of amounts recognized in financial statements. The presurvey materials provided three examples of innovative display.

How strongly do you feel that improvements are needed in the display of information in the balance sheet, income statement, or cash flow statement? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	48	50	45	54	46	56	43
Feel very strongly	17	18	15	19	16	16	15
Feel somewhat strongly	32	33	30	35	30	40	28
Feel not very strongly	28	27	30	25	28	34	27
Believe no change is needed	23	22	25	19	25	9	30
Not sure							

4. The next area deals with footnote disclosure of financial information about unconsolidated entities. Unconsolidated entities include 50 percent or less owned investments by one company in another company, partnership, or joint venture. The presurvey materials described the current disclosure requirements related to unconsolidated entities.

Our question relates to footnote disclosures about unconsolidated entities. How strongly do you feel that improvements are needed in disclosures of information about unconsolidated entities? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	82	81	83	83	79	85	83
Feel very strongly	44	46	40	49	43	44	40
Feel somewhat strongly	38	35	43	34	36	41	42
Feel not very strongly	11	12	9	10	14	9	9
Believe no change is needed	6	5	7	5	6	6	7
Not sure							

5. The next area of external reporting deals with the accounting for and the recognition of intangible assets, including goodwill. In current practice, only purchased intangible assets are recognized in financial statements. That is, intangible assets that companies develop internally are not generally recognized in financial statements. Current practice requires general statements about the identity and lives of recorded intangible assets. We have two questions about intangible assets.

5a. The first relates to the recognition of intangible assets in financial statements. How strongly do you feel that internally generated intangible assets (e.g.patents, trademarks, and goodwill) should be measured and recorded in financial statements? Do you feel strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	43	45	38	48	42	37	39
Feel very strongly	17	18	15	21	15	14	14
Feel somewhat strongly	26	27	24	28	27	23	26
Feel not very strongly	25	23	27	23	24	25	28
Believe no change is needed	31	30	34	28	32	38	33
Not sure							

5b. The second question relates to disclosures about intangible assets. How strongly do you feel that improvements are needed in disclosure about the identity, source, and life, of a company's purchased or internally generated intangible assets? Do you feel very strongly that such somewhat strongly, not very strongly, or do you believe no change is needed?

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	70	70	68	72	69	69	68
Feel very strongly	32	33	31	39	26	33	31
el somewhat strongly	38	38	37	33	43	36	37
Feel not very strongly	17	16	18	15	18	17	18
Believe no change is needed	13	12	13	13	12	14	13
Not sure							

6. The next area of external reporting deals with alternative accounting procedures, which for purposes of this question, are different accounting methods that can be used to report a similar class of transaction or event.

How strongly do you feel about the desirability in your work of narrowing the number of alternative accounting procedures so that, in general, companies would have only one method of accounting for a given transaction or event? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	67	65	70	62	69	67	69
Feel very strongly	35	35	37	34	37	36	37
Feel somewhat strongly	31	30	33	28	33	31	32
Feel not very strongly	17	18	17	21	15	22	17
Believe no change is needed	14	15	12	15	15	10	13
Not sure							

7. Our next question relates to disclosures about measurement uncertainties, which are defined and illustrated in the presurvey materials.

How strongly do you feel about the need to improve disclosures about measurement uncertainties? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	59	59	60	58	60	61	58
Feel very strongly	23	23	22	23	24	23	22
Feel somewhat strongly	36	35	38	34	36	38	35
Feel not very strongly	17	17	15	18	16	17	16
Believe no change is needed	13	14	13	13	15	11	14
Not sure							

8. The next area of external reporting relates to both the accounting for and disclosures about financial instruments and off-balance-sheet financing arrangements. In recent years, there has been an explosion in financial instruments and off-balance-sheet financing arrangement. We have two questions on this topic. The first relates to accounting and the second relates to disclosure.

8a. How strongly do you feel that there is a need to improve accounting for financial instruments and off-balance-sheet financial arrangements? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	86	87	83	88	86	86	81
Feel very strongly	53	54	50	55	53	59	44
Feel somewhat strongly	33	33	33	33	33	28	37
Feel not very strongly	8	8	9	6	10	9	9
Believe no change is needed	5	4	7	5	4	5	9
Not sure							

8b. Regardless of improvements in accounting for financial instruments and off-balance-sheet financing arrangements, there could be changes in disclosures related to those instruments and arrangements. For example, disclosures could (1) identify the financial instruments used and the off-balance-sheet arrangements entered into, (2) describe the business reasons for using those instruments and entering into those arrangements, and (3) discuss the risks involved with those instruments and arrangements. How strongly do you feel that changes are needed in disclosures about innovative financial instruments and off-balance-sheet financing arrangements? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no changes are needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	90	91	89	91	92	89	89
Feel very strongly	60	61	59	63	58	59	57
Feel somewhat strongly	30	31	30	27	35	30	32
Feel not very strongly	7	6	9	6	6	9	9
Believe no change is needed	2	2	2	3	2	2	2
Not sure							

**9. The next area of external reporting deals with interim reporting. Interim reporting includes all communications in external reporting other than those relating to annual periods.
It includes, for example, quarterly reports on form 10-Q, periodic reports on form 8-K, and press releases.**

How strongly do you feel improvements are needed in the timeliness, or content of, interim reporting? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no changes are needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	46	48	41	54	42	45	41
Feel very strongly	18	21	13	27	15	18	14
Feel somewhat strongly	27	27	28	27	27	26	27
Feel not very strongly	30	27	33	24	31	31	34
Believe no change is needed	24	23	25	20	26	21	24
Not sure							

10.The next area of external reporting relates to nonfinancial business information. By nonfinancial business information, we mean everything in external reporting except for information in the financial statements and the related footnote disclosures. The presurvey materials included a listing of the six types of information included in the nonfinancial business category.

10a. How strongly do you feel about the need to expand disclosures in external reporting of nonfinancial business information of the type included in the presurvey material? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no changes are needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	50	51	48	57	43	56	56
Feel very strongly	16	18	13	22	13	14	14
Feel somewhat strongly	33	33	35	35	30	43	32
Feel not very strongly	31	30	33	26	34	29	33
Believe no change is needed	18	18	18	15	22	14	20
Not sure							

10b. (ASK ONLY IF "NOT VERY STRONGLY" or "BELIEVE NO CHANGE NEEDED OR "NOT SURE" in Q. 10a) 10a.) Do you feel the way you do about reporting of nonfinancial information because you now have adequate sources for that information, such as from discussions with management etc., or not? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Have adequate sources of information	77	75	81	72	83	71	84
Do not feel that way	18	21	14	22	7	16	12
Not sure	5	4	5	6	10	13	4

(ASK EVERYONE)

11.The next area deals with forward-looking information. External reporting currently provides information about the past and present. It does not focus on forward-looking information. The presurvey materials listed five types of forward-looking information that could be included in external reporting. As the Special Committee has defined it, forward-looking information excludes projected or forecasted financial statements.

11a. We have two questions on forward-looking information. The first is this. How strongly do you feel that external reporting should be expanded to include more forward-looking information? Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	44	44	45	45	42	40	48
Feel very strongly	16	16	15	19	13	17	14
Feel somewhat strongly	28	28	30	26	28	23	34
Feel not very strongly	28	27	30	26	28	29	30
Believe no change is needed	26	28	23	27	28	30	20
Not sure							

11b. (ASK ONLY IF "NOT VERY STRONGLY" OR "BELIEVE NO CHANGE NEEDED"OR "NOT SURE" IN Q. 11a) Do you feel the way you do because you now have sufficient sources for forward-looking information other than external reporting, such as discussions with management etc., or not? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Have adequate sources of information	60	58	63	55	62	56	69
Do not feel that way	33	34	31	36	32	37	27
Not sure	7	8	6	9	6	7	4

11c. (ASK EVERYONE) The second question on forward-looking information relates to projected or forecasted financial statements. How strongly do you feel that external reportng should be expanded to include projected or forecasted financial statements. Do you feel very strongly, somewhat strongly, not very strongly, or do you believe no change is needed? (RECORD BELOW)

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
Total Strongly	36	34	41	34	33	32	45
Feel very strongly	12	11	13	13	9	9	17
Feel somewhat strongly	24	23	27	21	24	23	28
Feel not very strongly	27	28	26	29	27	26	25
Believe no change is needed	36	37	30	37	38	38	30
Not sure							

12. My questions thus far have addressed 12 areas for possible improvements in external reporting. Now, I would like you to consider the relative usefulness to your work of possible improvements in each of those areas. For each area, please indicate whether improvements would be of high, medium, or low usefulness in your work. In responding, you do not need to indicate an equal number of high, medium, or low responses.
(READ EACH AREA AND RECORD ANSWERS BELOW)

	Relative Usefulness: HIGH						
Area for Improvement	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
1.Disaggregated information	52	56	47	61	50	62	41
2.Fair value information in financial statements or in related footnote disclosures	45	46	45	44	48	40	45
3. Display of information in financial statements	32	34	28	38	28	26	29
4.Disclosure of financial information about unconsolidated entities	51	44	54	51	47	55	54
5.Accounting and disclosure for intangible assets, including goodwill	28	30	23	35	26	26	22
6.Narrowing the scope of alternative accounting procedures	33	33	33	32	34	28	31
7.Disclosures about measurement uncertainties	23	22	22	24	21	26	21
8. Accounting for and disclosures about financial instruments and off-balance-sheet financing arrangements	60	59	61	58	60	62	58
9. Interim reporting	26	28	25	35	19	29	29
10. Nonfinancial business information about the past and the present	23	25	20	28	22	22	24
11. Forward-looking information	26	26	26	29	23	23	30
12. Projected or forecasted financial statements	25	22	28	23	23	17	36

That completes our first series of questions on broad categories of external reporting. In our second series of questions, I would like to revisit a few of the broad areas in more detail.

Q. 13.

Let me ask you about a number of specific ideas related to disaggregated information. For each idea, tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the idea. We want to know what would be most helpful to you in your own work. (READ EACH ITEM AND RECORD BELOW)

	Agree Strongly						
	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
a. Companies should report disaggregated information based on industry segments.	48	57	30	61	50	58	26
b. Companies should report disaggregated information based on geographic segments.	22	29	11	33	24	22	3
c. Companies should report disaggregated information based on individual product lines, even if those lines are narrower than industry segments, if those product lines are important drivers of the company's opportunities and risks.	39	45	29	45	46	47	25
d. Companies should report disaggregated information based on the individual legal entities that comprise the company.	26	21	34	22	20	33	37
e. Many companies now report too few industry segments	35	41	26	44	38	36	20
f. Many companies now report too few geographic segments	18	20	16	21	16	17	15
g. Companies should determine geographic segments based on the location of their production facilities.	5	7	3	10	4	6	2
h. Companies should determine geographic segments based on the location of the markets in which they sell products or services.	42	48	34	47	48	39	32
i. Companies should determine industry and geographic segments based on how the company segments itself internally for reporting to senior management or the board of directors.	19	23	12	23	23	17	12
j. Companies should at least consider how analysts attempt to segment the company when deciding on industry and geographic segments.	29	33	25	35	30	36	22
k. Companies should determine their industry and geographic segments based on how competitors report their segments.	10	11	8	10	2	14	7
l. The level of detail of financial information about industry and geographic segments that companies report today is about right for my purposes.	9	10	8	11	8	6	10
m. Users need complete financial statements for each industry and geographic segment.	17	11	15	22	15	17	13
n. As a practical matter, companies should limit the segment financial data that they disclose to a handful of key statistics, as they do now.	9	7	11	7	7	3	12

Q.13 (CONT)

	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
o. As a practical matter, companies should disclose segment financial data at the same level of detail that senior management uses to manage the business.	16	20	10	22	10	22	18
p. Companies should report nonfinancial business information along the same lines that they report segment financial data. Thus, for example, management's discussion and analysis of operations should be organized according to the company's business segments rather than based on the company as a whole.	31	35	26	31	32	25	26
q. Companies should report disaggregated information as a part of any quarterly reports issued.	25	31	17	33	28	33	14

Q.14
Now I want to ask you about a number of specific ideas related to the display of information in financial statements. For each idea, tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the idea. Again, we want to know what will be most useful to you in your work.
(READ EACH ITEM AND RECORD BELOW)

	Total	Inves- tors	Credi- tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
a. Companies should do a better job of separately identifying the effects of unusual, infrequent, and nonrecurring transactions or events on the face of the financial statements or in related footnote disclosures.	48	45	54	51	36	50	54
b. One method of separately identifying the effects of unusual, infrequent, and nonrecurring transactions and events would be to distinguish between core and noncore earnings on the face of the income statement. Core earnings result from continuing, recurring, and usual operating activities. Conversely, the non-core category includes the effects of nonrecurring, unusual, and infrequent transactions or events, discontinued operations, and gains and losses from non-core assets and liabilities. How do you feel about separately displaying core and noncore earnings on the face of the income statement?	45	44	47	47	41	39	48
c. Companies should separately identify on the balance sheet and cash-flow statement those assets, liabilities, and cash flows that result from nonrecurring, unusual, and infrequent transactions or events.	50	51	50	54	47	47	52
d. In general, companies should increase the amount of detail displayed on the face of the financial statements.	27	29	25	31	26	31	24
e. In general, companies should provide more detail of items included in the "other" category, such as other income and expense, and other deferred charged and credits, using a lower materiality threshold than is currently used.	31	33	27	37	27	31	27

	Agree Strongly						
	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
f. Companies should provide more detail about the nature of and changes in valuation reserves, such as reserves for receivables and inventories.	31	31	31	36	24	36	30
g. Companies should disclose past-due receivables, or an aging of receivables.	34	30	42	30	30	39	46
h. Companies should disclose slow-moving inventory or an aging of inventory.	32	29	39	28	30	33	22
i. Nearly all companies report cash flows from operations using the indirect method. That method starts with net income and adds back noncash charges and credits to arrive at cash from operations. An optional method, which is rarely used, is called the direct method. That method starts with cash from revenues and subtracts cash paid for expenses to arrive at the same cash from operations. Users find acceptable the information provided by the indirect method, and do not need a change in practice to the direct method.	28	27	30	31	21	39	29
15. Next, I will ask you about a number of specific ideas about alternative accounting procedures. For each idea, tell me if you agree strongly, agree somewhat. disagree somewhat, or disagree strongly with the idea. Again, we want to know what would be most useful to you in your work. (READ EACH ITEM AND RECORD BELOW)							
a. Accounting standard-setters should not be changed to specify a single accounting method in areas where alternative methods could be equally appropriate, such as depreciation methods, or methods of accounting for inventories.	22	22	21	27	16	17	26
b. Standards currently require that some business combinations be accounted for as purchases, while others be accounted for as poolings of interests. Standards should not be changed to require that all business combinations be accounted for under a single method.	27	30	23	36	21	28	22
c. Standards currently require that some leasing transactions be accounted for as operating leases, and others be accounted for as capital leases. Standards should be changed so that all uncancellable leases with terms of more than one year should be accounted for as capitalized leases.	24	24	24	26	21	31	20

16. Next, I want to ask you about two ideas about measurement uncertainties. Once again, for each idea, tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the idea. Again, we want to know what would be most useful to you in your work. (READ EACH ITEM AND RECORD BELOW)

	Agree Strongly						
	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
16a. For each type of asset and liability that is particularly sensitive to measurement uncertainties, the notes to the financial statements should (1) disclose the significant uncertain conditions underlying the measurement, (2) discuss how amounts were derived, and (3) explain the basis of estimates, assumptions, and judgments used.	42	40	47	42	37	42	43
b. The notes to the financial statements should include a statement that uncertainties are inherent in measuring those items because estimates, assumptions, and judgment are necessary in determining their reported amounts.	31	30	31	32	27	28	30
Q.17 Next, I will ask you about several ideas about interim reporting. Once again, for each idea, tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the idea. Again, we want to know what would be most useful to you in your work. (READ EACH ITEM AND RECORD BELOW)							
a.External reporting should take place as soon as possible following a reportable event, but at least quarterly.	69	68	71	71	64	64	75
b.For critical transactions and events, such as business combinations, lawsuits, etc. information should be reported within a few days of the transaction or event.	60	65	52	65	64	64	52
c. SEC quarterly reports on Form 10-Q currently report both quarterly and year-to-date income statements. Rolling-12 month income statements should be added to the information in those quarterly reports.	15	20	20	20	21	33	10
d. If rolling-12 month income statements are added to SEC quarterly reports, it would be acceptable to delete the year-to-date income statements currently provided.	9	12	6	12	12	3	6
e. Interim reporting should include quarterly cash flow statements rather than the year-to-date cash flow statements as currently reported in SEC Form 10-Q reports.	22	25	16	27	24	36	10
f. Unlike current practice, companies should report complete fourth quarter information, even if that information is released concurrent with annual reporting.	43	47	37	48	44	53	33
g. If companies report separately on the fourth quarter, that reporting should focus on fourth quarter income and cash flow, and management's analysis of that income and cash flow, including significant fourth quarter adjustments.	46	47	43	51	42	58	40

Q. 17(CONT.)

	Agree Strongly						
	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
h. Current reporting on SEC Form 10-Q permits condensed complete financial statements. Instead, interim information should consist of financial statements in the same level of detail as in annual statements.	22	23	20	24	20	36	15

Q.18

My next few questions address the usefulness in your work of nonfinancial business information. In responding, don't consider whether the information is now part of external reporting. The choices in this series differs somewhat from the last few questions. In this group of questions, I will read a type of information. For each type,tell me whether that type of information is essential, helpful, merely interesting, or not useful in your work. (READ EACH ITEM AND RECORD BELOW)

	Essential Information						
Type of Information	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
a.Mission, broad objectives, and strategy to achieve the broad objectives.	16	19	11	17	21	19	11
b. Scope and description of the business and related properties held.	34	37	28	37	38	22	32
c. Description of the company's industry structure, such as information about (a) the ability of new companies to enter the industry, (b) the ability of substitute products or services to displace those produced by the company, (c) the relative bargaining power of resource providers, including employees, (d) the bargaining power of customers, and (e) the intensity of competition in the industry.	32	36	25	36	39	28	25
d. The identity and background of directors and management.	24	24	25	23	21	17	26
e. The identity and description of management incentive plans, including formulas used, if any.	25	30	16	29	32	8	16
f. The identity of major shareholders.	19	23	14	28	16	14	14
g. The identity and description of transactions and relationships among related parties.	41	41	43	43	38	50	28
h. Key nonfinancial statistics that management uses to run the business, in areas such as (1) market penetration and quality, (2) costs and productivity, (3) innovation, (4) timeliness to perform key activities, (5) amount and quality of key resources, and (6) resource provider satisfaction.	26	30	19	30	31	36	14
i. Management's discussion and analysis of key relationships in both financial and nonfinancial data and reasons for changes in data during recent periods, including the identity and past effect of key trends.	32	33	30	32	34	33	31

Q. 19

My next few questions address the usefulness in your work of forward-looking information, such as that described in the presurvey materials. Again, don't consider whether this is part of present external reporting. In this group of questions, I will once again read a type of information and you tell me if that type of information is essential, helpful, merely interesting, or not useful in your work. (READ EACH ITEM AND RECORD BELOW)

Type of Information	Essential %	Helpful %	Merely Interesting %	Not Useful %	Not Sure %
a. The identity and future effect of trends affecting the business.					
Total	31	56	10	3	_
Investors	33	56	8	3	_
Creditors	29	56	13	2	_
Equity Analysts	30	57	9	4	_
Debt Analysts	31	50	17	2	_
b. Opportunities and risks					
Total	28	54	14	3	1
Investors	28	55	15	2	_
Creditors	28	54	11	6	2
Equity Analysts	26	57	15	2	_
Debt Analysts	25	44	22	9	_
c. Factors or conditions internal to the company that are critical to achieving its objectives					
Total	50	41	7	2	_
Investors	52	40	7	1	_
Creditors	46	44	8	2	_
Equity Analysts	52	38	7	3	_
Debt Analysts	44	36	17	3	_
d. Management's major plans for future activities that will impact future cash flows.					
Total	57	38	5	_	_
Investors	57	38	5	_	_
Creditors	57	37	6	_	_
Equity Analysts	54	39	6	1	_
Debt Analysts	44	44	12	_	_
e. Comparison of actual business performance to previously disclosed forward-looking information.					
Total	21	57	17	5	_
Investors	21	58	16	5	_
Creditors	21	56	20	3	_
Equity Analysts	16	60	17	4	2
Debt Analysts	19	50	28	3	_

Q. 20.

20a. Our next question asks about information now provided in external reporting that you may <u>not</u> find essential in your work. Assume for purposes of this question, that improvements in external reporting require that external reporting include new types of information that you would find useful. In exchange for that information, would you be willing to give-up <u>some</u> <u>types</u> of information now in external reporting that are not as useful to your work as the new information that would be added, or would you not be willing to do that?

(INDICATE RESPONSE BELOW -- IF "YES, WILLING," CONTINUE ON WITH QUESTION 20b. IF "NO, NOT WILLING, GO TO QUESTION 21)

Type of Information	Total %	Investors %	Creditors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %
Yes, willing (ASK Q. 20b)	60	61	58	59	64	56	56
No, not willing (SKIP TO Q.21)	35	34	36	36	32	39	37
Not sure (SKIP TO Q. 21)	5	5	6	5	4	5	7

Thank you once again for your participation in this survey. We can assure you that the Special Committee will carefully consider what you have to say and what it has learned through this process.

Q.21
Next, I want to ask you about the credibility of external reporting. After I read each statement, tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the statement. Please base what you say on your personal experience. (READ EACH ITEM AND RECORD BELOW)

Statement	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	Agree Strongly						
	%	%	%	%	%	%	%
a. Overall, I am satisfied with the credibility of information in external reporting.	21	22	20	26	19	22	22
b. In general, rather than report neutrally, external reporting tends to portray the company in the best possible light.	34	37	28	37	37	35	26
c. Companies too often record unnecessary liabilities that could be used to adjust earnings in future periods.	13	16	8	16	15	8	9
d. Companies too often delay recognizing liabilities and expenses to avoid stepping-up to bad news.	28	29	25	27	31	24	24
e. Bias in external reporting is generally not a problem because I am usually able to identify any bias that is present.	7	8	6	9	8	6	6
f. Frequent write-downs of assets and recurring restructuring charges lead me to believe that asset values have been overstated in prior periods, resulting in a loss of confidence in financial reporting.	27	31	21	33	23	24	21
g. Use of certain financial instruments, off balance sheet financing arrangements, and other accounting practices serve to make companies appear less risky than they really are.	34	34	32	34	34	31	23

Q. 22
Next, I want to ask you about differential reporting. This topic addresses whether some companies should prepare external reports following different rules than other companies, depending on the company's industry, its size, whether it is public or private, or some other differentiating factor. I will read several statements. After I read each statement, tell me if you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the statement. (READ EACH ITEMS AND RECORD BELOW)

Statement	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
a. Under current rules, companies in certain industries use different accounting methods for certain transactions than companies generally. That practice should continue.	16	17	16	19	14	18	17
b. Under current practice, both large and small companies recognize and measure assets and liabilities using the same recognition and measurement rules. That practice should continue.	47	46	48	45	47	59	46
c. Under current practice, both public and private companies recognize and measure assets and liabilities using the same recognition and measurement rules. That practice should continue.	50	50	51	48	51	55	53
d. In general, both public and private companies should follow the same rules on the form and content of footnote disclosures in financial statements.	62	61	61	64	59	65	60

Q.22 (CONT)

Statement	Agree Strongly Total %	Inves- tors %	Credi- tors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %
e. Under current practice, the extent to which private report information other than information in financial statements, including required disclosures, is the subject of negotiation between the company and its investors and creditors. That practice ofnegotiation should continue.	22	21	24	21	22	41	19
23. Our next series of questions relate to auditor involvement with external reporting. And our next question specifically relates to auditor association with a company's financial statements. Do you agree very much, agree somewhat. disagree somewhat, or disagree very much that 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? (RECORD BELOW).	68	67	68	69	66	69	66
23b. The way it is now, auditors' reports use a standardized format that varies only in limited ways for unusual situations. Do you agree strongly, agree somewhat, disagree somewhat, or disagree strongly that the current standardized format of auditors' reports gives you what you need to know from auditors? (RECORD BELOW)	19	18	22	19	16	16	25
23c. Auditors' reports could cover any forward-looking information disclosed by management. This could include prospects for changes, identifying future key trends and their effects, opportunities and risks, factors or conditions critical to achieving corporate objectives, and management plans that could affect earnings and cash flows. Do you agree strongly that the auditors' report should provide some level of assurance about management disclosures of forward-looking information, agree somewhat, disagree somewhat, or disagree strongly?	21	22	21	22	22	8	28
23d. Auditors' reports could also cover non-financial business information disclosed by management. This could involve reporting on corporate objectives and strategies, and descriptions of industry structures and relationships. Do you agree strongly, agree somewhat, disagree somewhat, or disagree strongly that the auditors' report should provide some level of assurance on non-financial business information disclosed by management? (RECORD BELOW)	11	11	13	13	9	6	16

24. Auditors' reports could be expanded to provide commentary analyzing a number of issues involving corporate disclosures. Let me ask you about some of these possible commentaries in auditors' reports.

	Agree Strongly						
	Total %	Inves-tors %	Credi-tors %	Equity Analyst %	Equity Port. Mgr. %	Debt Analyst %	Credit Grantor %
24a. One area of possible auditor commentary would be measurement uncertainties. If corporate disclosures were expnanded to include significant uncertain conditions underlying specific amounts in financial statements, how amounts were derived and what estimates, assumptions, and judgments are based on, auditors could provide separate commentary on such matters. Do you agree strongly that such separate commentary should be included in the auditors' report, agree somewhat, disagree somewhat, or disagree strongly that a separate commentary on these uncertain conditions should be included in the auditors' report?	23	23	21	22	24	27	20
24b. Corporate financial statement disclosures now include descriptions of certain accounting principles underlying the financial statements. The auditors' report could include commentary analyzing these accounting principles in relation to other alternative accounting methods, particularly accounting principles used by other corporations in the same industry. Would you agree strongly that such commentary should be in the auditors' report, agree somewhat, disagree somewhat, or disagree strongly?	31	32	28	32	33	33	25
24c. Corporate disclosures could be expanded beyond present limits to reveal opportunities and risks management believes can expose the corporation to changes in future earnings and cash flow. Do you agree strongly that the auditors' report should include a separate commentary on such disclosures, agree somewhat, disagree somewhat, or disagree strongly?	16	18	14	18	17	8	15
25. Of course, if auditors' commentaries were included in their reports, they may well differ significantly or agree with management views. Let me ask you a few questions about this issue.							
25a. Suppose the auditors' commentary analysis is essentially the same as that of management. Do you agree strongly that it still should be part of the auditor's report, agree somewhat, disagree somewhat, or disagree strongly?	31	32	30	35	29	35	28
25b. And what if the auditors' commentary is significantly different from management's views, even though both might have real merit. Do you agree strongly that having the auditors' views would help you by providing distinct and independent views in addition to the reasonable views of management, agree somewhat, disagree somewhat, or disagree strongly?	52	53	49	54	52	51	48

	Agree Strongly						
	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
	%	%	%	%	%	%	%
25c. Matters such as accounting estimates, opportunities, and risks may turn out to have consequence in the future quite different from those discussed in an auditor's commentary. Do you agree strongly that, if that happened, the auditor's independence in making future financial statements would be <u>not</u> be affected, agree somewhat, disagree somewhat, or disagree strongly?	14	12	16	15	10	14	19

26. Expanding the auditors' report to include commentary could increase the costs of audits. Very roughly, what is the maximum cost that companies should incur to provide users with the benefits of auditor commentary in auditors' reports? Please express your response in terms of the percentage of the audit fee that you perceive is currently charged. Should the maximum cost be zero, 10 percent, 25 percent, 50 percent, or more than 50 percent?

	Total
	%
Zero	13
10 percent	42
25 percent	26
50 percent	3
More than 50 percent	4
Not sure	12

27 (Final Question) Improvements in external reporting could well result in increased costs. These costs include (a) costs of accumulating, auditing, and transmitting the information, (b) costs resulting from disclosing information to competitors and suppliers, and (c) costs resulting from litigation. The Special Committee is considering several rules that would limit the cost of providing information in external reporting. For each rule, please indicate whether you agree strongly, agree somewhat, disagree somewhat, or disagree strongly with the rule.

	Total	Inves-tors	Credi-tors	Equity Analyst	Equity Port. Mgr.	Debt Analyst	Credit Grantor
27a. Management should not be required to report information about other companies because, generally, management is not the best source for that information. Rather, the disclosures should emphasize how the environment impacts the company.	52	53	49	56	50	59	51
27b. Management should not be required to provide projected financial statements. Rather, management should provide information that helps investors and creditors project for themselves the company's financial future.	50	58	38	60	55	41	30
27c. Generally, management need only report what <u>nonfinancial business information</u> that it knows. That is, management should be under no obligation to search for nonfinancial business information that it does not have, or need, to manage the business.	47	49	43	51	46	47	40

	Total	Inves-tors	Credi-tors	Equity Analyst	Port. Mgr.	Equity Debt Analyst	Credit Grantor
	Agree Strongly						
	%	%	%	%	%	%	%
27d. Management should not report information that would harm the company's competitive position.	41	43	37	39	47	35	38
27e. There must be legal safe harbors for management's disclosures of forward-looking information. It is unreasonable to expect management to make candid disclosures of forward-looking information with a high risk of subsequent litigation with the benefit of hindsight.	62	62	62	58	65	65	61

Thank you once again for your participation in this survey. We can assure you that the Special Committee will carefully consider what you have to say and what it has learned through this process.

VI Report of the Committee’s Breakthrough Task Force

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The AICPA
Special Committee

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on Financial
Reporting

Report of the Breakthrough Task Force

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October 1994

AICPA Special Committee on Financial Reporting

Report of the Breakthrough Task Force

INTRODUCTION

The AICPA Special Committee on Financial Reporting (the "Committee") was formed to address increasing concerns about the relevance and usefulness of financial reporting. The Committee is charged with recommending (i) the nature and extent of information that management should make available to others and (ii) the extent to which auditors should report on various elements of such information.

In order to discharge this duty, the Committee is investigating, among other aspects, the directions in which the uses of business information are likely to evolve in the future as a result of changing social, political, economic, technological, professional, legal and other forces. A view of the future of business reporting is essential in order to make long-term recommendations and to ensure that the Committee's short-term recommendations, based on research of the needs of users of business information, are consistent with long-term trends. Furthermore, as the Committee's work progressed, it recognized that it would be difficult to develop a new business reporting model responsive to users needs and, at the same time, provide a "breakthrough" approach to business reporting, since today's users of financial information are likely to be constrained by the existing financial reporting model.

The Breakthrough Task Force was established to consider this longer-term view, in particular to contemplate the year 2005 and consider the nature of the reporting entity, who users of business information will be, the kinds of decisions such users are likely to be making in the year 2005 and the kinds of business information that such users will need to make those decisions. The objective of the Task Force is to examine the forces shaping the development of the global business environment in the year 2005 and to determine whether this vision warrants the pursuit of a breakthrough business reporting model.

The selection of the year 2005 is arbitrary; it is intended to be far enough in the future that it is reasonable to expect that the environment will be substantially different from the present and yet close enough to today so that many of those involved in providing and using business information today will have an interest in the outcome.

This report attempts to describe a future that will be created by the forces noted herein. Inexorably advancing technologies coupled with the inherent competitiveness of enterprises assures that the future will look very different from today. In this shifting environment, there will be winners (those that recognize and exploit opportunities) and losers (those that fall behind in their perceptions of the marketplace and their use of technologies). Nothing the Committee does will prevent that. However, these developments will be played out under a set of "rules of the game" (laws, regulations, norms, and professional standards). The rules of the game can be either beneficial (i.e., increase the efficiency and effectiveness of the game) or detrimental (i.e., decrease its efficiency and effectiveness). Our purpose is to make recommendations to revise those rules in a beneficial way to take advantage of the opportunities brought about by change.

A FUNCTIONAL VIEW OF ACCOUNTING

In assessing how any business reporting model that might exist in the year 2005 will be impacted by emerging trends, it is important to first understand the function of accounting. Simply put, accountability represents the basic features of accounting that are both original and permanent; that is, the characteristics of accounting that are so generic and essential that they remain unchanged regardless of time or circumstances. It is important to understand that while accountability has been recognized in the past as a primary feature of financial reporting; the views contained in those earlier treatises were far more narrow in focus and scope than those expressed herein.

In summary, accountability is a process activated by an obligation; one party owes and fulfills a reckoning to another party about some past or future action. The concept of accountability originates in the social need to co-operate. There is a fundamental need to work together, pooling resources and/or skills for a common goal or interest or for different goals or interests that can be achieved only by coordinated behavior.

In the context of business reporting, accountability encompasses the following basic elements:

(i) the reporting entity; the party who has the responsibility to report;

(ii) the user; the party who is entitled to the report

(iii) the obligation; the reason for the responsibility to report

(iv) the performance of the accountability; the preparation and issuance of the report.

The basic concept of accountability as it relates to financial reporting has been in existence for many years and will continue in existence. However, the individual parties and methods of fulfilling the obligations of accountability have changed, in some cases imperceptibly, and in others dramatically, over the years and are likely to continue to change.

The parties in an accountability relationship have potentially conflicting interests, because their interests in the information content of the reckoning differ. For example, in a cost-plus contract, the reporter wishes to maximize the reported cost and the reportee wishes to minimize it. This potential conflict gives rise to a need for attestation, which reduces the uncertainty as to whether the reckoning can be relied upon. Attestation adds confidence to transactions in the capital markets. To be effective, attestation requires the attestors to be competent in verification technology, to have credibility and to be proficient in the subject matter of the assertion to be verified. Credibility depends on integrity, but it can be assured only if the attestor has no interest in the information other than its accuracy. In addition to the demand for attestation and the qualifications of the attestor, the information must be verifiable in order for attestation to be effectively supplied.

DRIVING FORCES THAT MAY SHAPE THE BUSINESS REPORTING MODEL IN THE FUTURE

In considering the forces shaping the development of the global business environment in the year 2005, the Task Force identified the major trends or driving forces that may shape this environment.

These trends are based on assessments of developments presently occurring and assessments of developments and changes that may occur over the next decade. Although the Task Force decided to group these changes into five groups, that is not intended to imply that these changes can be looked at or considered in isolation from each other. While each of these trends represents disparate phenomena and while some aspects of these trends may even be viewed as contradictory, nevertheless each of the over-arching trends are interconnected and their interaction in the coming years will have a significant effect on business conditions in the future.

The five over-arching and interconnected trends identified by the Task Force are:

Widening stewardship obligations,
Changing financial context,
Changing relationships between institutions and their constituents,
Advances in technology,
Shifting relationships with governments.

The following is a brief outline of the various individual aspects within these categories which are driving and shaping the broader over-arching trends. The description of these items is not intended to be comprehensive or all-inclusive and some individual features may conflict with others.

Widening stewardship obligations
As the world population increases and industrialization expands there will be greater stress on the environment resulting in increased public expectations regarding the environment. These are but a few of the forces which will broaden stewardship obligations. This emerging concept of stewardship will also place greater emphasis on accountability. In environmentalism, for example, stewardship means a moral obligation to posterity for the well-being of the planet. This same perception of moral obligation is likely to entail more focus on integrity in business dealings with stakeholders. As a result, there will be increasing demands for entities to report their activities to a much wider group than just shareholders; for example, to employees, customers, government agencies and elements of the community. There will be increasing demands for more information and for different types of information. Increasing attention will be paid to the concepts of corporate governance and the growing influence of the institutional investor.

Changing financial context
The general pace of financial innovation has never been higher than during the past decade. There are reasons - based on secularly lower transaction costs, learning

curve costs, and developments in the modern theory of finance - to believe the pace can sustain itself into the future. The financial innovations represent more than just a vehicle for more efficient sharing of risks, and the segregation of financial and operating functions. They provide the basis for more rapid evolution of entire institutional arrangements (including geographical and political locations), and the creation of new institutions.

Financial innovations are rendering meaningless and arbitrary many of the elements of the traditional framework around which business is organized. For example, the economic distinctions between institutionally-defined debt and equity are becoming increasingly blurred. All of this suggests that the future will require major revisions in the accounting conventions used in contract enforcement and implementation of regulations. Moreover, financial innovations are only symptomatic of the strains being placed on traditional approaches to framing business activity. They illustrate a much more general point; i.e., that functions served by even longstanding institutions, including the traditional accounting framework, may be best served by quite different institutions in the future.

Changing relationships between institutions and their constituents

There will be increasing demands for more explicit contractual relationships so that the nature of a relationship is clearly evident. At the same time there will also be increasing changes in the relationships - both financial and non-financial - between an entity and its customers, suppliers of goods and services and suppliers of capital as various sectors arrange activities to achieve benefits from extended co-operation. This apparent conflict results from decreasing information technology costs which permit more explicit contracting, and increasing dependence on intellectual property rights which demands more relationship-based arrangements.

Advances in technology

International competition based on technological advances (physical, biological, and information technologies) assures that technological developments will continue to flow. Information technology, in particular, has the potential to transform all businesses. The inventions necessary to assure the continual plunge of information costs in real prices (per unit of information capture, storage, processing, and communication) have already been made, so real price declines at the same rate as in the past are virtually assured through 2005. For practical purposes, information in 2005 will appear to be "free" by today's standards. This will have profound implications for all businesses. Advances in information technology also suggests that geographical location will decline in importance and information will become available more widely and more quickly and at decreasing costs. Advances in technology developed to track physical assets, financial products and internal operations will result in more information becoming available for use in business reporting. As more information becomes available there will be increasing demands for sharing of that information.

Shifting relationships with governments

Government policies will increasingly affect business activities both in the financial sector and in non-financial sectors. Government economic policies will result in a shifting of business activities among the government and the private sector as well as between geopolitical boundaries -- witness the development of the European Community, NAFTA and the Pacific Rim alliances. Such alliances and improving technology suggest the decline of sovereignty and the increasingly prominent role that governments and geopolitical alliances will take on as ardent supporters for businesses within their borders and as fierce competitors for businesses that are looking to relocate. Greater interdependence, in the sense of both competition and co-operation, will develop among governments and businesses. The competition and co-operation will involve government at various levels within a country and internationally.

As mentioned above, the over-arching trends cannot be looked at or considered in isolation from each other. Rather, the confluence of these trends will impact the fundamentals which drive the business environment in the year 2005. It is these anticipated fundamental changes that the Breakthrough Task Force used as a foundation for its vision of the business reporting model in the year 2005.

The discussion of the driving forces shaping the business reporting model in the year 2005 is best understood if broken out into the following topics:

- The reporting entity and users of information.
- Availability of information.
- Costs of information.
- The tension between the desire for information and the desire for confidentiality.

The reporting entity and users of information

Traditionally, financial reporting in the United States has resulted largely from the conflicts created by an explicit or implicit contract between the suppliers of capital and the entity. Financial reporting, therefore, consisted of summarizing the results of transactions in order to show the profits available for distribution to the suppliers of capital. Whether this summary was prepared at the end of the business venture, annually or quarterly, the concept remained the same.

Accounting standards developed because of the need to ensure consistency and comparability in the manner by which transactions were summarized and allocated into discrete time periods such as years and quarters. Consequently, such standards enhance the cost efficiency of contracting.

Financial reporting and the business model today can be described as focusing on "arms length" transactions, primarily due to the historical orientation of business towards its suppliers of capital. However, entities are becoming increasingly more oriented towards key customers, suppliers, and employees as well as investors as these constituents become more vital to the success of all firms. These phenomena will have a significant impact on the nature of reporting entities, users and the information needs of users as the focus of business changes to recognize the importance of the closer and explicit relationships now developing. For example, the interest in business reporting is widening to include many other groups that are affected by the activities of a business entity - such as governments that shape the environment in which the entity operates, taxpayers, voters and the community at large. This widening interest in business reporting is expected to continue. These other groups are interested in business reporting of entities - but their interests and needs are diverse.

The four primary groups interested in business reporting may be described as representing the following interests:

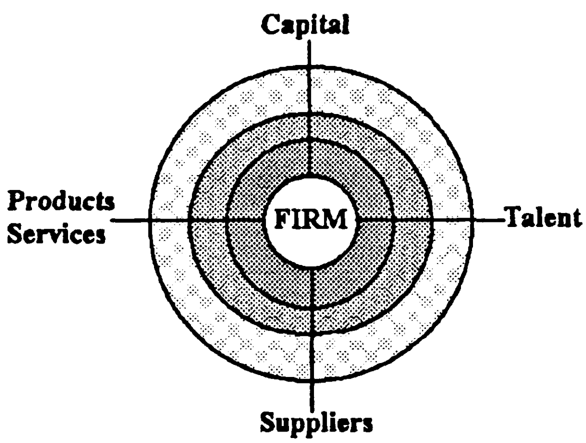
Capital:
- the suppliers of capital, that is, equity investors and debt holders.

Talent:
- the suppliers of labor, that is employees, including various managerial levels.

Suppliers:
- the suppliers of raw materials, equipment, service, technical expertise, key technologies, etc.

Products/services:
- the customers, that is the users of the products or services sold.

These groups - or markets - impacting the business reporting entity are depicted in the following diagram.



Nearly all entities compete in all four markets and are required to make decisions on what information to provide to the participants in each of these four markets to attract and retain capital, talent, customers and suppliers. The entity also owes accountabilities to the governments and communities which shape the environments in which it operates. However, typically the demands made by these groups can be satisfied through the compulsion of law, e.g., governments can demand an environmental impact statement. Consequently, they are not reflected in the above diagram.

The circles around the firm are not fixed in the sense of clear divisions between one tier and the next tier. The situation is more that of a continuum with each tier blending into the next and with the tiers within each market not equidistant from the entity. Where a particular user lies within this gradient will be a function of its importance to the entity and therefore the strength of its bargaining power as discussed below.

As an example, looking at the "Capital" market, the inner tiers in the diagram would likely include sole or majority investors, the middle tiers would likely include institutional investors and the outer tiers would likely include small individual investors. Similarly, in the "Suppliers" and "Product/services" markets, those in the inner tier would include other entities who were major suppliers to, or major buyers from, the reporting entity. These users in the inner tiers of the suppliers and products markets may be just as interested in the details of production, sales and operating data as users in the capital market.

Although these groups are all interested in the business reporting of the entity, their interests are different - because their intended uses of the information typically differ. In addition, within each group, there may be differing degrees of interest - again, because their intended use of the information may be different, and also because the closer the relationship between the group member and the entity (i.e., the more a party is dependent upon the entity for success), the more interested the user is in the information. Also, the differing tiers of relationship create different needs in terms of the levels of detail of the information. For example, those in the closer ranges are more interested in and demand more detail and richness of information because their own economic well-being is more closely dependent on the entity. It is, of course, more important for major players to get more information about a firm because their risks, and economic prosperity, likely are not as diversified as those of the less central players. Those in the closer ranges are also in a better position to influence the entity to provide more information. Undoubtedly, the degree to which any party can get information depends on its bargaining power with the firm. However, it is also important to recognize that the ability to utilize bargaining power as leverage for obtaining information is cyclical. Presently we are in a period of a buyers' market (at least in terms of capital), which reduces the leverage that a user in the capital market can utilize in its demands for richer information. This changes over time.

Individual parties in the outer ranges have less direct influence and therefore receive less information. However, such parties are not necessarily without power. For example, in the Capital market, regulators such as the Securities and Exchange Commission look after the interests of small investors and enable them to get relatively deep within the circles despite their modest bargaining power. In the Talent market, labor organizations are involved and can also provide considerable influence.

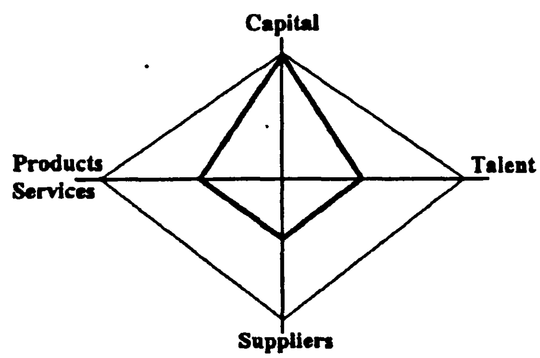
Furthermore, these other markets are expressing more interest in, and hence more demand for, information geared to their specific needs, and this trend is likely to expand. There appears to be a growing demand to broaden financial reporting beyond the needs of the capital markets in order to supply information to the other markets. Because the interests of these markets may vary considerably, broader dissemination of information may be necessary to efficiently satisfy their various needs.

The players in the inner circle for each market are dependent on the entity and, since the entity's health, which is important to them, is dependent on its competitiveness in all four markets, each of these players must be concerned with all four, and thus needs information about the entity's status in all four. Also, each of these four groups is, of course, not discrete. There could be many cross-overs and an entity or individual could hold an interest in one or all of the markets. For example, a major player in the capital sector would want to know about key employees, key suppliers and their technologies, key customers and the particular products.

As outlined in our discussion of trends, contracting costs are declining, thanks in large measure to decreasing information costs, which may drive the optimal and real size of entities downward. The size of the average legal entity will likely decline by 2005, as the entity and its suppliers, employees and customers work together in relationship based transaction systems and are likely to form closely linked "clusters" of entities that may be much larger than the consolidated legal entities that exist today. More significantly, the nature of these cluster entities will be different from the legal entities that form the basis of today's business and accounting models.

Users will likely request information about a "cluster" of entities; for example, a cluster consisting of a manufacturer plus a supplier of major components when the two are economically dependent on each other. It is quite possible that one particular "legal" entity could be part of more than one cluster as the grouping of entities into a cluster will vary with the needs of the particular user. One way of expressing this "cluster" concept is to describe it as a "virtual entity" which is a construct, enabled by technology, that looks like an entity to its users (e.g., customers) but is not.

The traditional focus of the US financial reporting model has been geared to the capital markets, as illustrated by the bold line in the following diagram. It is likely that the model will broaden to focus more on the talent, suppliers and products/services markets. This is reflected by the thin line on the diagram.



The bold diamond shown above must broaden in the US and be more consistent around the world to meet the expanding needs of the other market participants for business information. Nevertheless, the nature and level of information needed by a particular market may vary from the information requirements of other markets. Therefore, the information that is made available will have to be flexible to accommodate the differing needs of various users at different times and in different circumstances.

Availability of Information

Information has value to users. There is little doubt that information - if provided - will be used by someone who sees an advantage in so doing. Also, information, if distributed freely, will be used to its utmost limit until it loses value.

Business reporting is a broad concept that includes external financial reporting designed to provide financial statements for stockholders, management reporting designed to provide the information needed by management to run the business and other financial and non-financial information that stakeholders may be interested in. The tasks of investors and managers are essentially similar, though performed at different levels. Each is interested in selecting among competing investment alternatives so as to maximize the present value of future cash flows. Accordingly, the decision information used by each may be different in degree of detail or fineness. Although all of the information reflects the same underlying transactions of the business entity, there are considerable differences in the level of detail and emphasis.

For public companies in the US, some information in addition to the financial statements is made available to any interested user. For example, certain financial and non-financial information must be included in the Management's Discussion and Analysis (MD&A) and other information may be provided voluntarily in an entity's annual report. In addition, some information may be made available through other sources, such as specific industry publications and information provided to investment analysts. However, the demand for information is increasing.

In an open society, such as the United States, there is growing pressure for disclosure of more information and the desire of users for open access to information is expected to continue. This desire for access is further accelerated by the increased availability of technology.

Advances in the utilization of information technology are expected to continue. As a result, it will become possible for an entity to assemble and report extremely detailed records on a real-time basis. In addition, it is reasonable to assume that the costs of assembling and retaining information will continue to decline and that users of all types of information will become accustomed to ready access to real-time information.

Therefore, it may be assumed that some - probably many - users will demand real-time access to computer databases for information that goes beyond the summary of transactions currently presented in the financial statements of public companies on an annual and quarterly basis. The information asked for could relate to details of units of production as well as production costs, units of sales, etc., by product line. However, as further discussed under "costs of information," some assert that there are significant competitive disadvantages that increased disclosure brings.

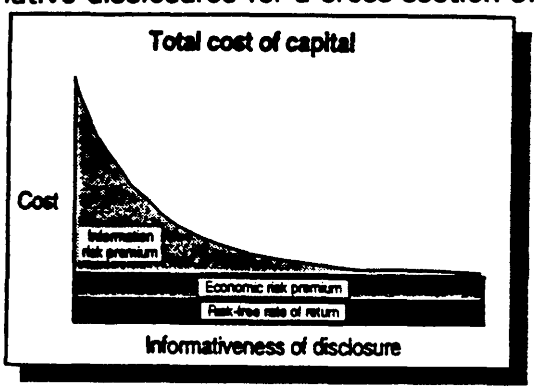
The ever-increasing stream of information available will become overwhelming to many users -- imagine all the data available from just the production activity of a Fortune 500 Company. This raises fundamental issues: (1) of all the available information, what will users need; (2) how much of this information should be made available to users, given competitive and other costs; (3) how can all this additional data be transferred into "knowledge" that can be effectively used; and (4) what will be the need for attestation of this data?

This expansion of the availability of information is likely to result in users having to choose the information that they wish to examine from large masses of information that is available. This will require users to develop interpretative skills to select the type and extent of information extracted from the total available pool of information and interpret the selected information according to their own needs.

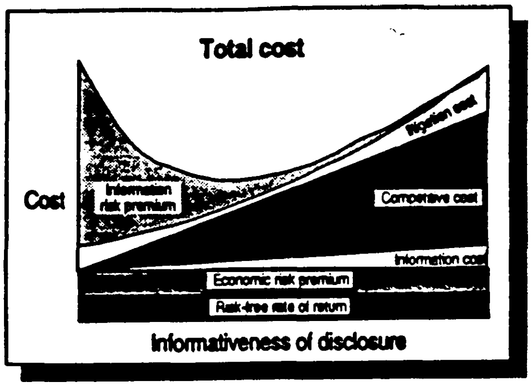
It is likely that a new market may develop for "information agents" who would act as intermediaries in reviewing the masses of information and extracting those parts of particular interest to a particular user. Such intermediaries would facilitate the access to and extraction of information relevant to a particular user for a particular purpose. Because the intermediary would filter out the clutter of extraneous information, such a facilitator would provide a value added service to users. With the advances in technology information systems, software will likely be developed to expedite such services. In fact, we can expect advances in information technology in the future to be more focused on the development of software to analyze and interpret data rather than the generation of increased volumes of data.

Costs of information

It has long been argued that the nature and extent of informative disclosures affect the cost of raising capital. While past research has been unable to prove this assertion empirically, intuitively it is reasonable to conclude that the cost of raising capital is lower in cases where more informative disclosures are provided versus situations where disclosure is unclear or incomplete. This difference in the cost paid to capital suppliers represents the cost associated with information uncertainty. The less information capital suppliers have about an enterprise, the less understanding they will have of the true riskiness of the entity and the higher price they will charge for capital. As an entity provides more information, uncertainty is reduced and the cost of capital falls. In the extreme, if a capital supplier knows everything about an enterprise, they will charge only the risk-free rate plus the premium for the true economic risk of the entity. These points are summarized in the following diagram. This diagram depicts the theoretical relationship between the cost of capital and increased informative disclosures for a cross section of reporting entities.



However, information is not free. To some degree, all information has the following costs associated with it: (1) costs of producing and disclosing information, including attestation costs, (2) costs incurred when competitors exploit the information to harm the enterprise, and (3) costs of litigation, which include defense costs, judgements and settlements. The relationship of each of these costs to the extent of the information content of disclosures is discussed below and depicted in the following diagram. It is important to understand that the context of the following discussion, particularly the relationships of increased disclosure on competitive and litigation costs, is focused on public companies, not private companies. In fact, the impact of competitive and litigation costs are often factors why entities chose not to raise capital in public markets.



Cost of producing and disclosing information
The costs of hardware, software and networks are plummeting and are expected to continue to decline in the future. These savings will reduce the costs of producing and disclosing information over time. If these were the only costs, it is clear that the lowest total cost over time would be achieved by continuously increasing the extent of disclosure.

Competitive costs
While difficult to measure, the cost to an enterprise resulting from the exploitation by competitors of information to harm the entity is potentially significant. An example of the competitive cost of information would be information disclosed by an entity that competitors use to deprive the entity of marketplace opportunities or to counter new strategies. Furthermore, the magnitude of competitive cost is likely to be greater than the cost of producing and disclosing information because the value of private information to a competitor is assumed to exceed the cost of producing and disclosing information.

By the year 2005, it is likely that competitors will be able to learn how to better exploit information to their advantage as a function of their own improved technology, among other factors. If they learn how to do this, the increased costs could more than cancel out the savings from information technology. In this case, the optimum level of disclosure could decline over time rather than increase.

Litigation cost
If an enterprise discloses too little information, it is likely to be sued for withholding vital information. On the other hand, the more it discloses, the more assertions (particularly forward looking assertions) are subject to ex post criticism through litigation. There is some thought that enhanced informative disclosures may actually result in reduced

litigation costs since there is an assumption that such disclosures would be accompanied by a full and fair discussion of various assumptions used, inherent risks and other uncertainties related to the additional disclosures. However, absent changes in our present legal system, additional disclosure will likely result in the perception by users that there are more "causes" for litigation. Even if the entity successfully defends itself, it will still incur additional defense costs. Therefore, it is likely that litigation costs will reduce the optimum level of information content over time.

When considering all these cost elements, it is likely that competitive costs will continue to be the dominant influence over the extent of disclosure, not litigation or the cost of producing and disclosing information.

The tension between the desire for information and the desire for confidentially

The depth of information disclosed by entities varies and, as previously discussed, the ability of a party to obtain additional information is a function of its bargaining power. In simple terms, the basic levels of information disclosure can be broken out into three layers as follows:

(Very sensitive information) Confidential disclosures
(Strategic information) Selective disclosures
(Public information) Disclosures of a public company

The information in the lowest level includes the disclosures required in existing financial statements and the additional disclosures made in MD&A and other documents required by regulators such as the SEC. The middle level represents disclosure of certain strategic information that may be needed to attract and retain certain investors, suppliers, talent and customers who have developed relationships and have a fair degree of bargaining power with the entity. The top layer represents the information needed by management to run the business and other financial and non-financial information that is demanded by the entity's most influential stakeholders.

It may be assumed that as users demand more information, and more specific information, from reporting entities, there may be tendencies within a reporting entity to desire to classify some information as confidential on the grounds that disclosure could impair the economic health and prosperity of the entity, because it may put the entity at a competitive disadvantage.

The tension between the needs of the user for access to information and the self-interest of the firm to retain confidentiality of specific information for competitive reasons is not new; it has been in existence since the initiation of public reporting and will continue to exist in the years to come. This inherent tension will be exacerbated in the future because of the increased availability of information and by competitors natural tendency for increasingly injurious use of information against the entity. This tension is magnified in those situations where the competitors are foreign-based and are not subject to similar reporting obligations and expectations. This is a significant problem that has already manifested itself in the US capital markets.

The underlying forces affecting disclosure levels can be summarized in the following chart.

Primary Forces Affecting Levels of Disclosure	
More disclosure	**Less disclosure**
• Decreasing information costs	• Competitive costs
• Broadening of the user group to include the "markets" previously discussed	• Management desire for latitude
• Litigation costs	• Litigation costs

The most important driving force behind the extent of disclosure is competitive cost. Preparers will be unwilling to extend the disclosure of information unless this real problem is mitigated. Competitors are likely to be able to injure an entity both more quickly, through their own use of information technology and more profoundly because of the increasingly short product cycles permitted by technology. Stakeholders need to be more conscious of this aspect; because while more disclosure may initially appear attractive it may ultimately diminish the value of their stake in the entity if such disclosures enable competitors to gain advantages. As discussed later in this report, the disadvantages presented by the ability for competitors to exploit information disclosed due to regulatory requirements to protect small investors could be addressed by permitting differential disclosure.

However, while increased disclosure will often aid the competition, in some cases the opposite is true in that it may ward off the competition - as in the well-known practice of pre-announcing products and freezing the market. More benignly, better information often leads to increased diversity and better positioning of companies, i.e., if two companies are competing for the same business, one of them will be at a disadvantage since the other is better suited to handle the business and it is inefficient for both of them to be competing. Better that the less suited should be going after another customer base with undiluted resources.

It is possible that the solution to the dichotomy between open and unrestricted access to all information and preserving confidentiality will be to layer the ability to access information databases. Databases are designed to permit differential disclosure, to permit access only to types of information that a particular user needs to know. For example, within the enterprise, the credit manager may have a credit view into the database that restricts him or her to only that information relevant to making credit decisions. Nothing prevents the enterprise from defining a "bankers' view," a "buy-side analysts' view," a "sell-side analysts' view," etc. These views could be more extensive to those who have executed nondisclosure agreements with the enterprise. Database security and encryption technology permit such differential disclosures to be secure from access by competitors.

As is the case today, certain users could have access to different levels of information depending on where they reside in the gradient of the diagram on page 6. For example, individual investors would likely be entitled only to the information provided at the first level of the diagram on page 11, whereas institutional investors, etc. would also receive the information on the second level. Sole owners/majority investors (the "privileged community") would demand and receive information at all levels. It should also be kept in mind that parties of lesser significance to the entity in each market can band together to achieve the bargaining power of the more significant players through trade unions, producers' co-operatives, buyers' co-operatives, etc.

Society in general may object to different levels of disclosure for different users. Individual investors may want the same access as institutional investors. Trade unions, the media and social pressure groups may want unlimited access. The pressures of an open society for open access to information is expected to continue. On the other hand, asymmetry of information disclosure is presently accepted in numerous facets of business and social life.

ATTESTATION

Attestation arises because parties in a relationship have potentially conflicting interests. The primary function of attestation is to enhance the efficiency of contracting by reducing the risks and uncertainties of information which, in turn, reduces transaction costs.

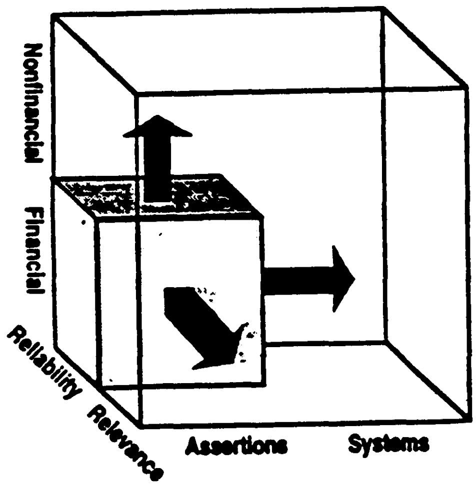
The Breakthrough Task Force considered these attestation issues and the relative state of the current attestation model. However, because the AICPA has recently formed a special committee on assurance, such consideration was limited.

Virtually all information is susceptible to some level of attestation - although the levels of attestation will undoubtedly vary and in some cases may consist only of assessing the steps undertaken in compiling the information. The fact that some information will be available on a real-time basis complicates, but does not, in itself, prevent attestation of such information.

In its broadest terms, the levels of attestation provided (or required) will be a function of (1) the nature of the information, ranging from "public information" to "very sensitive information," and (2) the bargaining power of the user. The level of attestation can also be a function of the size of the transaction (relative to each party), the information asymmetry between the parties, and the susceptibility of the assertions to attestation. See diagram on page 11. Different levels of attestation are also consistent with the model of differential disclosure. In addition to permitting different levels of attestation, the utility of the attestation model would be greatly enhanced if information was categorized or "tagged" using the following descriptions:

- Source of the information
- Relative reliability/volatility of the information
- Extent/depth of attestation performed

The possibilities for expanding the scope and value of attestation may be illustrated by the following diagram. Presently, attestation is, for practical purposes, limited to the cube bounded by reliability, assertions and financial information. The content of information subject to attestation could be expanded to include more non-financial business information. The form of attestation could be extended to include attestation as to the appropriateness of the systems that gather and maintain information in addition to individual assertions. Finally, the service feature of attestation could be expanded to include enhanced relevance in addition to reliability alone. The possibilities for attestation can be extended, increasing the size of the cube and, therefore, the value of attestation. However, the scope of attestation will be based on that which is negotiated between the reporting entity and the user.



CONCLUSIONS AND RECOMMENDATIONS

It is clear that the global business environment is changing rapidly and that the only certainty is that change itself will continue. As testimony to the importance of recognizing and managing change, John F. (Jack) Welch, Chairman and CEO of General Electric and widely acknowledged as the leading master of corporate change in our time, was quoted in a recent **Fortune** article as saying: "You've got to be on the cutting edge of change. You can't simply maintain the status quo, because somebody's always coming from another country with another product, or consumer tastes change, or the cost structure does, or there's a technology breakthrough. If you're not fast and adaptable, you're vulnerable. This is true for every segment of every business in every country in the world." It is in this spirit that the Task Force has developed the following conclusions and recommendations.

Conclusions

1. The reporting entity and the users of information.

   The entity providing financial and business reporting in the year 2005 will not be simply the legal entity or registrant as we know it today. In addition to the legal entity, the reporting entity is likely to also include clusters of entities that are involved in long-term business relationships. As a result, a specific legal entity may have to provide information on a number of different bases. This calls for a reconsideration of what the unit of accounting (reporting entity) should be.

The interest in business information by users other than the traditional suppliers of capital (e.g., the suppliers of labor; the suppliers of raw materials, technical expertise and consulting services; and the customers) will significantly increase as will their leverage to demand and obtain this information from reporting entities.

2. Availability of information.

The information expectations of users will be based on the broader concept of business reporting rather than restricted simply to financial reporting and will be more heavily influenced by markets outside of the capital suppliers. Information demands will be based upon all business activities of an individual entity, on selected business activities of an individual entity, and on selected business activities of a cluster of entities.

Business reporting will be available in many forms, such as computer databases. In addition, much of the information will be available on a real-time basis. Advances in technology will facilitate access to more information resulting in the desire of users for unlimited access to information.

Business reporting will be flexible, so that the individual user will have the ability to select the type of information desired and the ability to select the depth of detail of information desired. The potential cost, in a competitive sense, of unlimited access will result in the desire of entities for restrictions on grounds of confidentiality and to preserve the ability of entities to be flexible in their actions.

3. Costs of information.

To avoid the higher costs resulting from costs associated with competition and litigation, enterprises will likely:

(1) Seek ways to provide differential disclosure (for example, inform their suppliers in a way that does not inform their competitors).

(2) Direct their capital-raising activities to institutions that do not require public disclosure from which their competitors might benefit. Thus, instead of raising equity capital through the stock market or issuing commercial paper, they may prefer to borrow from a bank or investment company, which will respect their confidences. Not only would such a step reduce competitive information costs, but it would also ameliorate litigation costs.

4. Attestation.

Users will have a desire for business information to be subject to attestation, based on the size of the transaction relative to that user, the information asymmetry between the parties and the susceptibility of the assertion to attestation. The ability of those users to obtain the desired levels of attestation will be based on their bargaining power with the reporting entity.

5. Standards for disclosure of business information.

   By the year 2005, expanding globalization of business and the creation of truly international capital markets will increase pressure on standard setters and regulators to co-operate in establishing more uniform accounting and reporting standards throughout the world. Beyond the year 2005, it is likely that the standard setting role will be fulfilled by a world-wide standard setting organization.

Recommendations

The Breakthrough Task Force believes that the forces shaping the business environment in the year 2005 warrant the pursuit of developing a broad business reporting model that would attempt to satisfy the needs of all users. The Task Force recognizes that any system of business reporting will never be capable of satisfying all needs of all users; however, much can be done to help to satisfy such needs by providing more of the information that an expanded group of users want. The Task Force recognizes that one of the most important problems facing the development of a broad business reporting model is the inherent tension between the users perceived "right to know" and the entity's "need for confidentiality."

The Task Force believes that this issue of how much and what type of information should be available to all potential users is perhaps the most significant matter affecting the future of business reporting. The Task Force recommends that standard setters, regulators and the accounting profession should work together to develop this concept of the broader business reporting model and to determine what standards and procedures may be necessary for its implementation. The following are recommendations as to how the process could be started.

1. Standard setters and regulators

The Financial Accounting Standard Board (FASB) should have a process in place to and consider address all of the ramifications concerning the various types of information that could be disclosed in a broad business reporting model and provide guidance on the type of information that could be disclosed. The development of a broad business reporting model should be responsive to shifting entity boundaries, the importance of "knowledge" related assets and other key trends identified in this report.

The Securities and Exchange Commission (SEC) should work closely with the FASB on the extended disclosures of business information. In doing so, the SEC should consider modifying laws and regulations that would eliminate barriers to companies experimenting with broader disclosures by creating effective safe harbors and establishing more effective deterrents to unwarranted litigation arising from information made available in good faith. The SEC should also consider the issue of differential reporting and the potential benefits it provides to the entity and the users in the entity's four key markets by reducing the competitive cost of undifferentiated disclosure.

2. The accounting profession

The American Institute of Certified Public Accountants (AICPA) should work closely with the FASB on the extended disclosures of business information. In addition, the AICPA should recognize that current rules limit opportunities for auditors to enhance the value of the attest function. The special committee on assurance recently formed by the AICPA should consider:

- providing guidance on information that could be subject to different levels of attestation;
- providing guidance on attesting to information gathering systems; and
- providing guidance on information that should not be subject to attestation.

In carrying out this review, the AICPA should ascertain the expectations of users with respect to attestation and the different levels of attestation that would be acceptable to users.

3. The international aspect

The increasing effects of globalization and the changing geopolitical environment will increase the need for more uniformity and comparability in financial and business reporting. International organizations such as the International Accounting Standards Committee (IASC), the International Organization of Securities Commissions (IOSCO) and the International Federation of Accountants (IFAC) are aware of these changing factors and are working towards international standards.

The international accounting standards that currently exist are not entirely compatible with US standards; in particular US standards are generally more prescriptive and call for more disclosures than are required under international standards. This unlevel playing field may be disadvantageous to US business entities.

The Task Force recommends that the US standard setters, the FASB and the SEC should work with the international standard setters with the intention of achieving consistency and unity between US and international standards, with the objective of meeting users' needs for information.

4. Costs and benefits of disclosure

The business reporting model in the US is perceived to be the most comprehensive in the world. However, some have argued that such a comprehensive model has resulted in a loss of US competitiveness. The Breakthrough Task Force cannot decide for US business or investors what the optimal amount of disclosure is, but can point out what is technologically possible and the types of costs and benefits. There is no "right" answer; but the accounting profession, the FASB, the SEC, and the Congress must make choices.

We believe that the cost/benefit question is a threshold issue and that standard setters, regulators and the profession should make these choices on an informed basis. Accordingly we recommend that an initiative be undertaken to improve the understanding of costs and benefits of business reporting. The objectives of such an initiative should include a focus on how additional disclosures impact the cost of capital and a better understanding of competitive costs. This initiative should involve standard setters, regulators, the profession, preparers, users and academia.

* * * * *

In summary, the Breakthrough Task Force believes that business is going through a transformation - a revolution - and that users want more information and more timely information; that this desire for information will expand and become more vociferous as the "information age" progresses. The Task Force believes that standard setters, regulators and the accounting profession must recognize that a paradigm shift is taking place and that more users are more interested in "quality" and "relevance" of business information rather than just "reliability" of financial information contained in the financial statements. In particular, the Breakthrough Task Force believes that the standard setters, the regulators, and the accounting profession must expand their horizons beyond financial information and be proactive, not simply reactive to changes taking place in the business community. The vision of the future of business reporting should be very broad and consider the information needs of all users of business reports, including equity investors, credit grantors, customers, suppliers, employees, and others. Standard setters should consider involving experts in various disciplines - such as finance, account, economics, law, business strategy, behavioral science, and technology - in developing a long-term vision. Those functional experts could provide fresh insight about long-term trends that will shape the future.

APPENDIX: Members of Breakthrough Task Force

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VII Bibliography of Source Documents Referred to by the Committee

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Special Committee on Financial Reporting

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