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Business reporting in an era of change

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BUSINESS REPORTING IN AN ERA OF CHANGE

by

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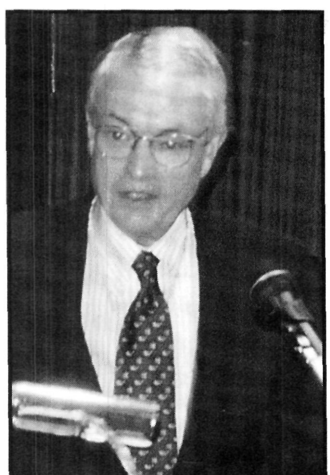
The following is based on the keynote presentation at the Academy's Research Conference in Atlanta on November 13, 1998.

Introduction

It's a great pleasure to be with you this morning to participate in your conference on the subject of the Evolution of Business Disclosure.

I understand this is the 25th anniversary of your Academy and 1998 also marks the 25th anniversary of the FASB. So being with you today has a special significance from a historical perspective.



I also want to thank Gary Previts, not so much for inviting me to this conference, although I do thank him for that, but for all of his help and counsel and support over the years–particularly on the subject of business disclosure.

I have chosen to discuss "Business Reporting in an Era of Change." I don't want to preach to the choir, and you seem to have the market tied up in terms of history. So I'll talk more about the present and future.

I also don't intend to speak for too long in the hope that we can have a good discussion when I'm finished.

I can't begin however, without one little historical note. I can clearly recall that in the 1960's an objective of Arthur Andersen, at least, was to develop financial statement presentations that were clear enough that no footnotes were necessary. We often met that goal, with the major exceptions being where there was a material uncertainty overhanging the company–usually one leading to a qualified auditor's report. What a change from today! And, what a complex world we live in.

Business Reporting: A Cornerstone

People in every walk of life are affected by business reporting, the cornerstone on which our process of capital allocation is built. An effective allocation process is critical to a healthy economy that promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Conversely, a flawed capital allocation process supports unproductive practices, denies cost-effective capital to

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companies that may offer innovative products and services that add value, and undermines the securities market.

Without adequate information, users of business reporting cannot judge properly the opportunities and risks of investment alternatives. To make informed decisions, they need a variety of information, including data about the economy, industries, companies, and securities. Complete information provided by the best sources enhances the probability that the best decisions will be made. And for company-specific information—which is key because companies are the sources of cash flows that ultimately result in the return on securities or the repayment of loans–management often is the best source. Business reporting packages management's company-specific information and delivers it to users in a meaningful way.

Few areas are more central to the national economic interest than the role of business reporting in promoting an effective process of capital allocation. It simply must be made to work as well as possible.

Business Reporting in an Era of Change

Increased competition and rapid advances in technology are resulting in dramatic changes. To survive and compete, companies are changing everything–the way they are organized and managed, the way they do work and develop new products, the way they manage risks, and their relationships with other organizations. Winners in the marketplace are the companies that are focusing on the customer, stripping away low-value activity, decentralizing decision making, reducing the time required to perform key activities, and forming new alliances with suppliers and customers–even competitors. They are setting the pace for others that must, in turn, reexamine their businesses in light of the increased competition.

In response to increased competition and changes in their businesses, companies also are changing their information systems and the types of information they use to manage their businesses. For example, they are developing new performance measures often designed to focus on activities that provide long-term value and competitive advantage, including non-financial measures such as product development lead time and financial measures such as economic value added.

Can business reporting be immune from the fundamental changes affecting business? Can effective business reporting exclude new performance measures on which management is focusing to manage the business? In times of rapid change, the risk increases that business reporting will fall behind the pace of change, failing to provide what users need to know. Today, more than ever, business reporting must keep up with the changing needs of users or it will lose its relevance.

Highly relevant business reporting also is important for the long-term vitality of the accounting profession. Accountants–those in industry, public accounting, education, and research–are closely associated with the process of business reporting and have an interest in ensuring its relevance. This task is analogous to the product and service redesign undertaken by many successful businesses to meet customer needs better. Cost-effective improvements in business reporting will enhance its value both to users and to the profession, just as improvements in products enhance value both to the consumer and to the producers of those products.

The Need for Reporting Standards

Some constituents, including many companies, while acknowledging the importance of high-quality business reporting, question, the need for standards improving business reporting. They ask: Why not let the marketplace for capital determine the nature and quality of business reporting? The marketplace, they argue, already offers powerful incentives for high-quality reporting. It rewards higher quality reporting and punishes lower quality reporting by easing or restricting access to capital or raising or lowering the cost of capital. Additional reporting standards, they argue, would only distort a market mechanism that already works well and would add costs to reporting, with no benefit. They liken reporting standards to costly, inefficient, unnecessary bureaucratic regulations.

However, reporting standards play an important role in helping the market mechanism work effectively for the benefit of companies, users, and the public. More specifically, reporting standards are needed because they:

- *Promote a common understanding of terms and alternatives that facilitate negotiations between users and companies about the content of business reporting.* Today, for example, many loan agreements specify that a company provide the lender with financial statements prepared in accordance with generally accepted accounting principles. Both the company and the lender understand that term. The company understands what must be done to prepare those statements and the lender is comfortable that statements prepared according to those standards will meet its need for information. Without standards, the statements would be much less useful to the lender, and the company and the lender would have to invent for themselves satisfactory standards–which would be inefficient and less effective than using generally accepted standards.

• *Promote neutral, unbiased reporting.* Companies may wish to portray their past performance and future prospects in the most favorable light. Users are aware of this potential bias and are skeptical about the information they receive. Standards help insure more neutral, unbiased reporting, which, in turn, builds credibility and confidence in the capital marketplace to the benefit of both users and companies.

• *Improve the comparability of information across companies.* Without standards, there would be little basis to compare one company with others–a user goal and a key feature of relevant information. Just as "truth in packaging" regulation enables consumers to compare the contents of food products, so should standards for business reporting promote comparability of information about companies.

• *Permits audits of information.* Auditors verify that information reporting in accordance with standards; without standards, audits would be less meaningful.

• *Facilitate retrievability of information by organizing data according to a framework.* A consistent approach to organizing the presentation of information assists users in accessing information in an efficient manner and facilitates prompt decision making.

For many years, financial statements and, in the broader arena of business reporting, filings with the Securities and Exchange Commission (SEC) have been prepared following standards, producing highly useful information. Standards in business reporting have proven their worth.

What I have just said was taken, nearly verbatim, from the first chapter of the Comprehensive Report of the AICPA's Special Committee on Financial Reporting, which I had the privilege to chair. To me those words are a good summary of:

• The need for sound, comprehensive business reporting–an efficient and effective capital allocation process.

• The focus of business reporting on investors and creditors–the users of information.

• The reasons the nature of business reporting is changing–technology, changes in businesses and how they are managed.

• The need for reporting standards—but much broader than a focus on financial statements and the notes thereto.

<u>The AICPA Special Committee on Financial Reporting</u>

The Special Committee was formed out of a concern that financial reporting no longer was as relevant as it should be. And, if that was so, then how relevant was–or would be–the accounting profession. At the start, the Special Committee's focus wasn't on users and it wasn't on business reporting either. Consider the Committee's name–"Financial Reporting."

We soon found however, that we weren't any better at "fixing" financial statements than any other prior study group or the FASB itself. We were each burdened by our backgrounds, biases and experiences. We needed focus and a common objective.

The purpose of financial reporting and business reporting is to provide information for decision making. We decided to focus on those who make decisions—investors and creditors—the users, indeed the customers, of business information. We also concluded that the users that needed this information were those that could not compel receiving the information.

In the end the title of our report was, "Improving Business Reporting—A Customer Focus–Meeting the Needs of Investors and Creditors."

The Special Committee found, when it completed its work, that most of the information needs of investors and creditors were outside of the traditional boundaries of financial statements and related notes. As a result we developed a much broader business reporting model–a comprehensive model consisting of ten elements. And, we concluded that to meet user's changing needs, business reporting must:

(a) Provide some information with a forward-looking perspective, including management's plans, opportunities, risks, and measurement uncertainties.

(b) Focus more on the factors that create longer term value, including non-financial measures indicating how key business processes are performing.

(c) Better align information reported externally with the information reported to senior management to manage the business.

The FASB's Business Reporting Research Project

The Special Committee's recommendations were passed on to, among others, the FASB. In some sense. I now find myself the recipient of my own recommendations. So much for passing the buck!

The FASB then issued an Invitation to Comment on what it should do with the recommendations. The responses were mixed, with many respondents concerned that the FASB would set standards for reporting information outside the financial statements. They feared that the Boards' standards would be too prescriptive and result in a boiler-plate approach in areas that cried for flexibility and presenting the information from a management perspective. Respondents also were concerned that the standards might lead to the information being subject to audit with all of the costs and other baggage attendant thereto.

However, the respondents did confirm the importance of the business reporting information, and the effort provided an opportunity for the Board to affirm that it's mission encompassed a broader scope than only financial statements.

Finally, in January, 1998, the Board decided to undertake a research project–not a standards-setting project–in this area. The overall objective is to identify and make publicly available best practices in a variety of industries for disclosures of business information. This, it is hoped, will result in the voluntary flow of more meaningful data to investors and creditors and serve to keep U.S. business reporting on the cutting edge of global reporting.

The project is underway and is expected to be completed in two years. It involves a coordinated effort between the FASB and its constituents with most of the resources coming from the later, including the academic community. Those involved are divided into teams with each of five teams studying two industry groups, one team working with the SEC to coordinate GAAP and SEC disclosure requirements and eliminate redundancies, and a final team studying the electronic delivery of information.

The interest in and enthusiasm for this project on the part of those participating bodes well for its success.

The FASB's Disclosure Effectiveness Project

One of the recommendations of the Special Committee was that "standard setters should search for and eliminate less relevant disclosures." As far back as 1980 when the Board issued an Invitation to Comment, Financial Statements and Other Means of Financial Reporting, the FASB has been concerned about disclosure effectiveness. However, little was done other than address the cost-benefit question as a part of individual standards.

However, in 1995, the Board issued a prospectus on the subject in direct response to the Special Committee's recommendation. Among the responses were suggestions to develop a conceptual framework for disclosure, but the Board concluded that not enough information was available at the time to develop such a framework.

So, the Board took an inductive approach and addressed disclosure effectiveness in the context of disclosures about pensions and other postretirement benefits. The result was Statement No. 132, issued in February of this year.

The Board continues to be interested in this topic. It may take another existing standard and consider how the prescribed disclosures could be improved. It may consider in current standards projects whether some disclosures are primarily transition oriented and thus subject to a sunset provision. It may take another look at developing a conceptual framework for disclosure. In any or all of these potential projects, the focus should be the same–providing effective information for decision making by investors and creditors.

The Current Need for Improved Business Information

The current situation in Asia, particularly Japan, Russia, and Brazil make crystal clear the need for better and more credible information for decision making. This need when juxtaposed with the present focus on developing global financial reporting standards and the recent attempts in Congress to derail the FASB's project to provide better information on derivatives and hedging activities, should spur the accounting profession, of which we are all a part, to continue to work on behalf of investors and creditors.

The global financial market place is here–or nearly so. It is being led by technology and the resulting instantaneous access to information. We need a global business reporting system to serve that market. And, it will happen because both companies and investors will demand it, and they deserve it. Instantaneous access to information is only as good as the information provided, and recent events have shown that global business reporting is not yet good enough.

Lawrence Summers, deputy secretary of the U.S. Treasury summed it up when he said recently, "...the single most important innovation shaping (the American capital) market was the idea of generally accepted accounting principles. We need something similar internationally."

Conclusion

Carved in the Supreme Court are the words, "The Past is Prologue." It's said one Washington, DC taxi driver explained that to some visitors as meaning, "you ain't seen nothing yet." Now that may not be quite how you accounting historians would explain the phrase, but I believe that the evolution of business reporting will continue, that it will be broader in its scope, while at the same time more focused on its purpose. It will be global in its coverage, while directed toward management's actions and plans, It will meet the decision making needs of investors and creditors.

In other words, you ain't seen nothing yet.