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Financial Statements: General-Purpose Financial Statements

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was refreshed and anxious to begin the second half of her day.

As the first part of her day had begun with the news, so did the second. Daily newspapers had become so cumbersone and voluminous that it would take the average person all day to read one. Since most people tended to read only those parts which most interested them: politics, sports, or editorials, it was commonplace to subscribe to a library filtering service rather than to the newspaper itself. The newspaper was divided into its most common denominators by the library service, and individuals such as Josephine had personal terminals in their homes. With a few punches of program buttons, preferred parts of the news were audible over a device similiar to the old-time radios.

An hour later Jo sighed a deep sigh. She always ended her news selection with news reports on the lighter side, and with the comics so as to avoid being left with a feeling of depression. She also avoided news stories about killings and brutalities. Still, after hearing the news from Washington she always felt a little saddened that the United States was no longer a leading nation.

The next two hours, as always, were devoted to Jo's continuing education program. She fitted her probes for electronic brain stimulation, turned on her in-home, shared-time, computer terminal and pushed the appropriate buttons for her computerized programmed learning course.

By 7:00 p.m. Jo was ready to put away the cares of the day and turn to more romantic pursuits. Tonight she had a date with a medical student, in his eighth year of medical school. Jo was serious about this young man and hoped that if they did marry, they might be able to get as many as two birth permits, since they were both professionals with high IQ's. Only special couples could get more than the one permit, which was necessary to obtain birth pills as an antidote to the birth control preparation which was continuously poured into all drinking water sources by order of the World-Government.

After a delightful evening of nonharmful diversion, an outdoor play beautifully illuminated by an artificial moon the size of a city block and a romantic walk in an expensive but safe private park, Jo was ready to return home, program her electronic brain stimulator for a nice romantic dream to continue her present mood and fall into a deep and restful sleep.

Financial Statements

General-Purpose Financial Statements

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Repair, Renovate, or Replace

The cease-fire agreement between the godparents of the accounting process has been broken.[1] At stake is the guardianship of the accounting process, and the outcome of the approaching battle will determine the future course of the accounting profession. Accounting's godparents — the AICPA, SEC, FASB, and Congress — are preparing to do battle in the public arenas of the courts and the Halls of Congress.

The AICPA cites parental rights and the care and guidance given during infancy and the formative years in support of its claim for guardianship. It also points to its longstanding working arrangement with the SEC as proof of its ability to assume responsibility and work with its peers, using as evidence the arrangement whereby it established measurement standards and SEC established reporting standards for publicly held corporations. SEC insists that the Securities Acts of 1933 and 1934 give it full legal guardianship. It further contends that it is not precluded from entering the measurement area if it believes that the AICPA is not adequately meeting its responsibilities, and that any future arrangements will be controlled by the SEC.

FASB supports its claim to guardianship on powers delegated to it by both the AICPA and the SEC. (It cites as the basis of its claim the actions of the AICPA Council that stated that FASB Standards constituted GAAP and Rule 203 of the Code of Professional Ethics that requires member adherence to GAAP promulgated by the body designated by the Council.) It further supports its claim by SEC's announcement in ARS #150 that FASB's Accounting pronouncements would be presumed to have "substantial authoritative support."

Congress has served notice through its Metcalfs and Mosses that the guardianship arrangements will be reexamined. It insists that the other godparents have been self-serving and have done a miserable job of protecting the public. It contends that the "Big Eight" accounting firms constitute a cartel designed to limit competition. The cartel is accused of controlling the AICPA and the FASB with the tacit consent of the SEC. Congress is demanding an examination of the entire "establishment" with the possibility of guardianship being awarded to the Federal Government. It cites as its source of power the duty and responsibility to protect the public interest. Eagerly waiting in the wings to accept the mantle are such governmental agencies as the FTC, GAO, and CASB.

Pressure from the consumers.

The consumers of the accounting process gird for their own skirmish. As the godparents marshall their troops for the larger war, the users want an immediate summit conference to determine the fate of the communications center known as "financial statements." They claim that much of the transmitted information from the center is garbled and of low quality. Also, there are frequent blackouts and much needed information is never received. They remind their protectors that the financial statement center has evolved without any real guidance; that the foundation was poured many years ago during the infancy of the process; the various additions and remodelings have taken place without any overall objectives; and that the resulting structure reflects parental and architectural neglect.

The godparents are also reminded that other structures in the accounting process compound have not been neglected: the data processing center was completely rebuilt a few years ago; the measurement center, also housing the library, has a corp of architects continuously at work keeping it ready to meet changing needs; and, that the auditing center has recently been remodeled and renamed SAS. Yet, the financial statements center, resembling a much neglected and added-to victorian boardinghouse, has received little attention.

The statement users believe that their problems cannot wait for the conclusion of the guardianship war: they ask that a summit conference be convened to determine if the structure should be: (1) retained as a historical landmark and museum (necessitating many repairs); (2) remodeled within the present overall structure; or, (3) replaced by a new structure. They request that an immediate task force be appointed to survey the structure and make recommendations, and that the chosen task force be given the following summary of the development of the present structure.

Development of the financial statements structure center. The development of the financial statement structure is analogous to the victorian house that was built to satisfy the needs of one family, but was later converted to a boardinghouse to house various occupants. Through its many changes the basic structure still produces general-purpose financial statements. In 1970 the AICPA reaffirmed its support for general purpose financial statements when it issued APB Statement no. 4. The statement asserted that one of the basic features of financial accounting was general-purpose information.

By the end of the 14th century the original structure was complete. The first level contained two large rooms aptly named *Assets* and *Liabilities*. Storage space for similar items was provided in the form of accounts. The simple balance sheet was prepared by listing the various accounts housed on the first level. The second level, also divided into two rooms, provided for accounts that were listed on the profit and loss statement. (Later renamed the income statement.) One room accommodated income accounts and the other expense accounts.[2]

As the accounting process matured, the four rooms no longer met user needs. The first level rooms were partitioned to provide for the arrivals of three sets of twins (current, long-term, and deferred), plant and equipment, and intangibles. With the arrival of Capital Stock and Retained Earnings, a new wing was needed to accommodate them. During the early years of the accounting process the first floor was widely used since the balance sheet satisfied the needs of the majority of users. Few ventured to examine the income statement.

However, as the number and diversity of users increased, they began to ask questions about the information stored on the income statement level. The SEC insisted that information be presented in more detail, especially in the income statement. The new interest centered on the statement resulted in the partitioning of the second level to make room for additional information. The income room was partitioned into sales, dividends and interest, service fees, and gains. The expense room partitioning yielded space for cost of sales, numerous selling and administration expenses, and losses.

As business operations became more complex and the statement served more consumers, the need for still more information became evident. Porches were enclosed to provide space for other arrivals: Extraordinary Items, Discontinued Operations, and Accounting Changes.

The space in the second level over the wing added to house Capital Stock and Retained Earnings was used with the appearance of another statement — the Retained Earnings Statement. In the early years space was relatively uncluttered since ARB No. 43, had expressed a preference for the all inclusive income statement. Thus, space was needed for accumulated retained earnings, net income for the year, and dividends. However, in later years APB, an adult child of AICPA, decided that prior year errors should also be lodged in the unit. The godparent FASB got into the act by ruling that gains or losses resulting from the decline of the market value of long-term equity securities and the write-off of R & D costs should be transferred to the wing. Seeing the new clutter in the unit the FASB investigated the problems created by prior year errors but could not reach a decision in regard to treatment.

As consumers became accustomed to receiving more information they began to realize that the accounting process was capable of generating even more. They complained that the structure of the Balance Sheet, the Income Statement, and the Retained Earnings Statement no longer served their needs. They began to wonder about events that were not reported in those statements. Of interest, but unreported, were various investing and financing activities. This desire for more information led to the opening of the unused attic to hold information for yet another major statement. Unfortunately, agreement still has not been reached on the best format or content of the new statement. It was not christened until the APB made it mandatory. Its prime purpose is to explain the sources and uses of funds, but there is no concensus on the meaning of funds. During its developing stages the statement was known by such titles as **"Where Got-Where Gone," "Sources and** Uses," and "Funds Flow." A continuing skirmish exists between cash and working capital as to which is the most important. Presently, working capital seems to be winning since its approach is used the most, yet cash rightfully insists that its approach gives the most information. One of the major items to which the task force should direct its attention is the format of the statement, since APB in opinion 19 decreed that it be called "Statement of Changes in Financial Position."

Alas, as new users came to the boardinghouse so did the demand for extra information. Dormers and gingerbread were added in the form of schedules and footnotes. The footnotes amplified information that was already in the statements and could be placed directly on the statements, but schedules required extra space. For example, the latest FASB requirement on segmental reporting required new space, but the new lease requirements and the SEC's requirement of replacement cost information could be placed in footnotes. However, many think that "the extensive use of footnotes has hindered the proper development of the statements themselves because it has resulted in the substitution of footnotes for better information in the body of the statement."[3]

The Problem

Constant pressures from many groups indicate that the present financial statement structure does not adequately serve the changing consumer demands. As the entities served by the statements evolved so did new users and new statement uses. Goods and services are produced by the interaction of the human element with other elements in the environment. The environmental influences are constantly changing. The characteristics of our economic organization — private ownership of productive resources, role of the market, free labor, and money as the "standard of value" — are undergoing change. Demands of one group of users may conflict with the needs of another group. Prior response to these needs has been to attempt to add more information into the existing statements.

The present statement structure assumes that all users have common needs. This may be somewhat true of owners and creditors but not of other direct users such as management (from the Board of Directors to the unit supervisor), taxing authorities, employees and customers. Then there are the indirect users: financial analysts and advisors, stock exchanges, lawyers, regulatory and registration authorities, financial press and reporting agencies, trade associations, labor unions, environmentalists, and various groups concerned with the social welfare. In fact, how much is really known of the needs of the users?

Despite efforts to meet changing demands we have yet to structure statements that begin to give desired information. Bedford states "there are **thousands of forces ranging from** political changes through technological developments to changes in personal values of individuals that tend to change the substance of accounting information."[4] Even the stockholders and creditors are receiving insufficient information. The objectives Study, released in 1973 by AICPA, states "An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty."[5] Present statements, dominated by historical events, give little information that aids in the predicting process, especially in regard to timing and uncertainties. FASB also acknowledged the need for information on future cash flows when it issued *Tentative Conclusions on Objectives of Financial Statements.* In the Letter of Transmittal for *The Accounting Establishment* Senator Metcalf stated, "Congress has established as national policy that a proper role for the Federal government should be to insure the free flow of accurate and meaningful information, but that goal has not been adequately fulfilled."[6] When he was chief accountant of the SEC, John C. Burton attacked financial statements on the basis of their disclosure inadequacies.

Differential Disclosure — A Possible Solution

The diverse and often conflicting needs of the direct and indirect users of financial information have received little attention until recent years. The focus has been concentrated on common needs. Many environmental changes have occurred since 1970 when APB statement No. 4 was issued. There appears to be movement away from the concept of a single set of financial statements to differential disclosure. *Differential disclosure is the reporting of different financial information to different users,* and it is based on the theory that information has different degrees of utility for different users. Examples of typical areas of interest for selected statement users follow:

Short-term creditors are interested in short-term cash flows.

Long-term creditors are interested in both long-term and short-term cash flows.

Large stockholders are interested in the long-run prospects of the firm.

Small stockholders are interested in current dividends and stock values.

Sophisticated investors want information about profitability of major product lines.

Unsophisticated investors could use glossaries, primers on financial analysis and other tutorial materials.

Financial analysts are especially interested in segmented disclosure and in information aiding interfirm comparisons.

Employees want information on job security and retirement benefits.

Macroeconomic decision makers ask for a more accurate picture of the true economic position.

Accounting theorists emphasize the need for cash flow and replacement value information.

The general public shows increasing concern about the problems of the physical environment and under its "right to know" asks for information on how the concern is meeting its social responsibilities.

Governmental units need diverse information but they have the power to demand what they need.

Attempts to modify present general-purpose statements might satisfy some users but could diminish the utility to others. All segments of society appear to be insisting on an expansion in the scope of accounting disclosures. Many believe that the concept of a single set of general-purpose statements cannot survive. Warns Burton, "A major change in financial reporting will be the development of reporting at various levels of detail, rather than an emphasis on a single set of data for all."[7] The SEC has taken a step in the direction of differential disclosure by allowing varying levels of summarization in different reports and, requiring specified information dependent upon the size and composition of the reporting unit.

Specialized statements designed according to needs of the users appear to offer the greatest utility. The general public and regulatory agencies might like to see "social" accounting, but of what use is this to the creditors? Increased segmented reporting would be welcomed by analysts, but of what use would this be to the small investor? The entire concept of general-purpose financial statements flies in the face of the forces of increasing specialization which is shaping today's world:

If we know that information of a certain kind is necessary for specified purposes, that knowledge dictates the shaping of the information. Toolmakers make tools for specified purposes. They do not make "screw-drivers" with a blade at one end, a serrated shank, and a hammer handle because some tool users may want a screwdriver, some a saw, and some a hammer.[8]

Bedford writes:

A more realistic approach would be to designate the audience for whom the disclosure is intended and develop communication devices suitable for transmitting accounting information to that audience. Clearly the notion of a general purpose accounting disclosure to all people for all situations for all times poses an impossible communication problem...[9]

There are many benefits that would derive from the adoption of the concept of differential disclosure. The first and most obvious is that the needs of each class of users can be met without sacrificing the needs of other groups. Also, the threat of governmental regulation of accounting would probably be reduced. There is evidence that failure to meet the needs of users leads to governmental regulation. (The passage of the SEC laws is a prime example.) The Metcalf report and Congressional Hearings on the report indicate that more regulation may be imminent.

A further potential benefit might be wider ownership of shares, and a probable reduction in the level of public ignorance about business. Increased capital market efficiency is likely; increased knowledge should lead to better investment decisions and therefore better capital allocation. More realistic reporting of the economic position of businesses could result in more intelligent tax policies and attention to the substantial capital formation needs of American business.

The major disadvantage of differential disclosure is its added cost. However, recent technological developments in the area of information storage and retrieval are lowering some of the costs associated with data processing. Also, data base management systems are now available which make specialized disclosures possible and feasible. Because most arguments against differential disclosure will center on the added costs involved they will be hard to answer. It is impossible to answer with a rigorous cost/benefit analysis, given the difficulty, if not impossibility, of quantifying the benefits to be derived.

The problem of unfairness or assurance that no user group is placed in priviledged position can be dealt with by making specialized reports available to all, on an elective basis. This is presently being done with the 10K report; it is available to anyone upon request. It seems reasonable that users would elect to receive only those reports containing information that they need and can use.

Conclusion

While fully differentiated disclosure cannot be achieved overnight, it is imperative that accounting professionals recognize the necessity to work to achieve its reality as soon as possible. Disclosure problems cannot await the decision on the guardianship (or joint-guardianship) of the accounting process. The present financial statement structure should be replaced. The new one must be designed and structured to meet the changing needs of the 20th century. However, we cannot abandon what we have until we have researched user needs. User needs must be the major determinant in the design of a new communication center.

FOOTNOTES

[1]The Accounting Process as used in these comments includes all phases of accounting, i.e., data accumulation, storage, processing, measurement, reporting, and verification.

[2]For an example of income statement and balance sheet of the late 14th century see: A.C. Littleton and B.S. Yamey. *Studies in the History of Accounting,* Irwin, Homewood, 1956, p.142-145.

[3]Marshall S. Armstrong, "Disclosure: Considering Other View's," *Financial Executive,* 46 (May 1976) p. 37.

[4]Norton H. Bedford, *Extensions in Accounting Disclosure,* Prentice-Hall, Englewood Cliffs, 1973, p. 20.

[5]Accounting Objectives Study Group, *Objectives of Financial Statements,* AICPA, N.Y., N.Y.: 1973, p. 20.

[6]Committee on Government Operations, *The Accounting Establishment,* GPO Washington: 1976, Letter of Transmittal.

[7]John C. Burton, "The Changing Face of Financial Reporting," *Journal of Accountancy,"* 141, (February 1976) p. 62.

[8]Raymond J. Chambers, "Accounting Principles or Accounting Policies?", *Journal of Accountancy,* 135, (May 1973) p. 51.

[9]Bedford, *Extensions in Accounting Disclosure,* p. 58.