Meeting the Information Needs of Investors and Creditors

THE AICPA SPECIAL COMMITTEE ON FINANCIAL REPORTING

About the Committee

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

The Committee's work is part of the AICPA's broad initiative to improve the value of financial information and the public's confidence in it. The broad initiative seeks to:

- Enhance the utility of business reporting
- Improve the prevention and detection of fraud
- Assure the independence and objectivity of the independent auditor
- Discourage unwarranted litigation that inhibits innovation and undermines the profession's ability to meet evolving financial reporting needs
- Strengthen the auditing profession's disciplinary system

Just as successful businesses align the features of their products and services with the needs of their customers, so, too, should the providers of business reporting align the features of business reporting with the information needs of those who use it. Recognizing this, the Committee based its recommendations on an unprecedented in-depth study to learn directly from users their information needs. The Committee also recognized the significant costs that can result from business reporting, and it considered cost/benefit issues in developing recommendations.

The Committee is not a standard-setting body. It offers its recommendations for the consideration of all those who have an interest in furthering the cost-effective quality of business reporting. If subsequently pursued by standard setters or regulators, the recommendations will be subject to full due process.

Key Points About the Committee's Work

1. Business reporting serves a critical role in supporting effective capital allocation. In many respects it serves that role well, providing those who use it with essential information. However, profound, accelerating changes affecting business threaten the continued relevance of business reporting. To stay relevant, it must change in response to users' evolving needs for information.

2. To meet users' changing needs, business reporting must:
- Provide more information about plans, opportunities, risks, and uncertainties
- Focus more on the factors that create longer-term value, including nonfinancial measures indicating how key business processes are performing
- Better align information reported externally with the information reported internally to senior management to manage the business

3. Users believe that auditor involvement with financial information is essential. To serve its customers better, the auditing profession should prepare to be involved with all types of information in business reporting to the extent companies and users may decide is necessary.

4. Because business reporting is not free, improving it requires considering the relative costs and benefits of information, just as costs and benefits are key to determining the features included in any product. Undisciplined expansion of mandated reporting could result in large and needless costs. In forming recommendations, the Committee adopted a flexible, cautious, and practical approach, proposing ideas supported by users that would result in useful information while recommending constraints on disclosure when costs could be significant.

5. Participants in the business reporting process must do a better job of anticipating change by:
- Focusing on users' information needs and finding cost-effective ways of better aligning reporting with those needs
- Developing and maintaining a comprehensive model reflecting the kinds of information that users need (the Committee has designed and illustrated such a model)
- Adopting a longer-term focus by developing a vision of the future business environment and users' future needs for information

6. The current legal environment discourages companies from disclosing forward-looking information. Companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation.

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 market for the purchase and sale of securities and the obtaining and granting of credit. Whether a *Fortune* 500 CEO, investment professional, or retiree, individuals make important investment decisions every day—or rely on others to make decisions for them—based on the information in business reporting. While the topic may not immediately capture one's imagination, few areas are more central to national economic interest.

Without adequate information, users cannot properly judge the opportunities and risks of investment choices. 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 source of cash flows that ultimately drive the return on a security or the repayment of a loan—management often is the best source of information. Business reporting packages management's company-specific information and delivers it to users in a meaningful way.

Business Reporting: *The information that a company provides to help users with capital allocation decisions about the company. It includes a number of different elements, with financial statements as one of those elements.*
Capital Allocation: *The process of determining how and at what cost money is allocated among companies.*
Users: *Investors and creditors, including potential investors and creditors, and their advisors who use business reporting as a basis for their capital allocation decisions.*
Comprehensive Model of Business Reporting: *A complete listing of the kinds of company-specific information that businesses could provide, at reasonable cost, to meet users' needs for information.*

Business Reporting in an Era of Change

Increased competition and rapid advances in technology are driving 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 who must, in turn, reexamine their businesses in light of the increased competition.

In response to 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, including nonfinancial 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 and value of the accounting profession. Accountants—those in industry, public accounting, education, and research—are closely associated with the process and have an interest in ensuring its relevance. The Committee's work 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.

A Focus on Users—The Customers of Business Reporting

Businesses everywhere have renewed their focus on the needs of their customers. Satisfaction surveys, focus groups, and cooperative ventures with customers abound. The insights gained from the renaissance of customer-focused activity are driving critical improvements in the quality, cost, and responsiveness of products and services around the globe.

Just as successful businesses align the features of their products and services with the needs of their customers, so, too, should the providers of business reporting. Recognizing this, the Committee concentrated on the information needs of users to help identify and evaluate ideas for improvement.

The Committee conducted extensive research to determine the information needs of users and identified the types of information they believe most useful in predicting earnings or cash flows to value equity securities and to assess the prospect of repayment of debt securities or loans.

The Study

The Committee designed the study to ensure that findings were representative of a broad group of users and to distinguish between the types of information they really need versus the types that are interesting but not essential. It also considered how users' needs for information might change over time.

To help ensure representative results, the study focused on direct input from users and rejected speculative data. It also involved multiple projects, each of which analyzed information needs from a different view. Finally, the study focused on information from groups in addition to individuals, including a number of surveys and documents from users' associations.

To distinguish between more important and less important information, the Committee inventoried information needs based on how users value companies and assess the prospect of loan repayment. It also gathered data about the relative priority users place on different kinds of information, which helped rank potential improvements.

For a longer-term view, the Committee gathered information about trends that are shaping business activity and considered the implications of those trends on the information needs of users.

Focusing on the Customer

The study included:

- *Analysis of documents created by users or based on research directly with them about their needs for information, including business and investment models*
- *Formal discussion groups including portfolio managers, analysts, and bankers representing large and small institutions*
- *Meetings with members of the Financial Accounting Policy Committee of the Association for Investment Management and Research (AIMR) and the Accounting Policy Committee of the Robert Morris Associates*
- *Discussions with other users*
- *Committee-sponsored research that inferred needs based on the types of information that analysts include in their reports and the types provided by businesses outside the financial statements*
- *An extensive survey of users*

Balancing Costs and Benefits

Because business reporting is not free, improving it requires considering the relative costs and benefits of various types of information. A practical balance must be struck in weighing the costs and benefits of information, just as costs and benefits are key to determining the features included in any product.

The Committee considered the costs of providing each type of information that its research suggested users need and screened from further consideration the types it judged to be too costly in relation to the benefits. The screening process included discussions with financial executives of large public companies, including a working group sponsored by the Financial Executives Institute.

Auditors who serve smaller companies also provided input on the costs of reporting, as did standard setters, regulators, users, and others. This screening process produced an information package designed to be both useful and sufficiently cost-effective to merit consideration by standard setters.

Weighing the costs and benefits of possible improvements to business reporting is difficult and complex. It is impossible to measure many of the costs and benefits of improved disclosure, such as the cost of disclosing competitively harmful information or the benefits to the economy of another piece of useful information. In addition, the costs and benefits are widely scattered, and many people are affected in different degrees.

While difficult, cost and benefit decisions must be made. On the one hand, business reporting must be enhanced to maintain its relevance, while, on the other hand, undisciplined expansion of mandated reporting could result in large and needless costs. Faced with this dichotomy, the Committee adopted a cautious and practical approach, proposing ideas supported by users that would result in truly useful information while recommending constraints on disclosure when costs could be significant.

The Committee believes that its recommendations are sufficiently cost-beneficial to merit consideration by standard setters, who would—as a matter of course—perform further cost and benefit analyses as a part of their due process.

Practical Constraints

The Committee's approach to its recommendations reflects the following constraints to limit the costs of reporting:

- Business reporting should exclude information outside of management's expertise or for which management is not the best source, such as information about competitors.
- Management should not be required to report information that would significantly harm the company's competitive position.
- Management should not be required to provide forecasted financial statements. Rather, management should provide information that helps users forecast for themselves the company's financial future.
- Other than for financial statements, management need only report the information it knows. That is, management should be under no obligation to gather information it does not have, or need, to manage the business.
- Certain elements of business reporting should be presented only if users and management agree they should be reported—a concept of flexible reporting.
- Companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that discourages companies from doing so.

> *"The U.S. reporting system is the best in the world. The Committee reaffirmed that and has come up with refinements rather than throwing out the whole process and starting over."*
>
> KENNETH J. JOHNSON
> *Vice President, Controller, and Director of Internal Audit*
> *Motorola*

A lot is right with today's business reporting in the United States. It generally provides users with essential information that heavily influences their decisions. In particular, financial statements are viewed as an excellent framework for capturing and organizing financial information. Users have welcomed improvements in business reporting, but few suggest that it should be scrapped and a new framework developed.

Yet, many users are strongly critical about certain aspects of reporting. Understanding the reasons for the criticism—much of it substantive—has identified high-priority areas for improvement. Some companies, particularly the larger ones, may already provide all the information that meets users' needs, but many do not. Those that do, provide it in a variety of ways rather than in a comprehensive, integrated format.

Based on the information needs of users as well as the costs and benefits of suggested improvements, the Committee recommends changes in four areas: improving the types of information in business reporting, improving financial statements, improving auditor involvement with business reporting, and facilitating change.

IMPROVE THE TYPES OF INFORMATION IN BUSINESS REPORTING

1. Standard setters should develop a comprehensive model of business reporting indicating the types and timing of information that users need to value and assess the risk of their investments.

In business reporting, standard setters long have recognized the usefulness of models or frameworks. However, existing models focus on financial statements rather than on the broad range of users' information needs. A comprehensive model, based on the following concepts, would help focus attention on a broader, integrated range of information and provide the foundation for future improvements to business reporting. Much of the information in the model would replace, not be in addition to, information currently contained in annual and quarterly reports and filings with the Securities and Exchange Commission (SEC).

The Committee's model also better aligns business reporting with the information management uses to manage the business and provides for a flexible approach that limits the types of information reported to that which users and preparers agree should be provided.

Divide reporting into elements that address the broad range of users' needs for information. As financial statements provide a useful structure for financial information, so would the other model elements provide a useful structure in the broader arena of business reporting.

The Ten Elements of the Committee's Model of Business Reporting

To assess the feasibility of its ideas, the Committee designed and illustrated a comprehensive model based on the concepts described. It includes ten elements within five broad categories of information that are designed to fit the decision processes users employ to make projections, value companies, or assess the prospect of loan repayment. The model also includes practical constraints to balance the costs and benefits of reporting.

The model differs from current SEC reporting in two key respects. First, it suggests that high-level operating data and performance measurements—which help users understand the linkage between events and their financial impact on the company and the factors that create longer-term value—become an integral part of business reporting. Second, it includes more forward-looking information, which would provide insight about management's vision and the opportunities and risks of an investment or a lending decision.

"Nonfinancial performance measurement–such as measuring customer satisfaction or the speed at which new products move from the development stage–would be very helpful to investors and analysts. Companies should report this type of information to provide a complete picture of their operations."

PETER C. LINCOLN
Vice President
U.S. Steel and
Carnegie Pension Fund

Financial and nonfinancial data

- Financial statements and related disclosures
- High-level operating data and performance measurements that management uses to manage the business

Management's analysis of the financial and nonfinancial data

- Reasons for changes in the financial, operating, and performance-related data, and the identity and past effect of key trends

Forward-looking information

- Opportunities and risks, including those resulting from key trends
- Management's plans, including critical success factors
- Comparison of actual business performance to previously disclosed opportunities, risks, and management's plans

Information about management and shareholders

- Directors, management, compensation, major shareholders, and transactions and relationships among related parties

Background about the company

- Broad objectives and strategies
- Scope and description of business and properties
- Impact of industry structure on the company

Allow for flexible reporting. Because users differ in their needs for information, not all companies should report all elements of information. Rather, companies should report only those elements of information that users and preparers agree are needed in the particular circumstances.

The Need for Flexible Reporting

Users differ in their needs for information. A short-term trade creditor may need far less information than a long-term equity investor. Requiring all companies to report all elements of the model would result in excessive costs and, in many circumstances, provide more information than users need.

Thus, business reporting should include at least the financial statement element and such other elements of the model as users and companies agree should be provided in the particular circumstances.

Since regulators already require much of what is included in the model, they probably would choose to receive from public companies most, if not all, of the model's elements. On the other hand, nonpublic company owners and lenders probably would limit reporting to specific elements required for their purposes.

Provide forward-looking information as well as historical information. Users focus on the future while today's business reporting focuses on the past. Although information about the past is a useful indicator of future performance, users also need forward-looking information.

Report on each business segment. Multi-segment companies operate diverse businesses that are subject to different opportunities and risks. Many users view business segments as the engines that generate future earnings or cash flows and, thereby, drive returns on investments. Segment information for each element of the model provides additional insight about the opportunities and risks of investments and sharpens predictions. Because of its predictive value, improving segment reporting is of the highest priority.

Focus on the information that senior management uses to manage the business. Many users want to see a company through the eyes of management to help them understand management's perspective and predict where management will lead the company.

Focus on measurement. While descriptions of business events are important, numbers are important too. Management should disclose the financial and nonfinancial measurements it uses in managing the business that quantify the effects of key activities and events.

Balance the costs and benefits of business reporting. Standard setters and regulators should continue to be sensitive to the costs of business

"*The Committee suggests that there be more information with a future orientation although not necessarily a published forecast. I think it's good that there is someone pushing in that direction.*"

JOHN C. BURTON
Professor of Accounting and Finance, Columbia Graduate School of Business, and Former Chief Accountant, U.S. Securities and Exchange Commission

reporting and search for ways to limit the costs of that reporting while still providing more useful information.

2. **Improve understanding of costs and benefits of business reporting, recognizing that definitive quantification of costs and benefits is not possible.**
   Despite the importance of cost/benefit decisions, much of what is written is speculative in part because definitive quantification of costs and benefits is impossible. But progress can be made, through additional research and discussions with users and preparers, in identifying the different types of costs and benefits, as well as their range and relationships, to facilitate deliberations and improve decision making.

IMPROVE FINANCIAL STATEMENTS

Users generally are comfortable with the framework provided by financial statements, and standard setters should retain their basic form and content. However, several areas in financial statements should be enhanced to meet users' needs for information.

1. **Improve disclosure of business segment information.**
   For many users analyzing a company involved in diverse businesses, financial data about business segments is as important as information about the company as a whole. Users complain that many multi-segment companies report too few or no business segments or report business segments in their financial statements different from those discussed elsewhere in business reporting. Users also complain about insufficient detail about a company's investments in, or affiliations with, other entities that are not consolidated in the company's financial statements. They suggest that standard setters assign the highest priority to improving segment reporting.

Segment reporting should be improved by better aligning the information in business reporting with the segment information that companies report internally to senior management or to the board. Thus, for example, in defining segments for business reporting:

- The fact that a company defines more segments for internal reporting than for business reporting strongly suggests that it should expand the number of segments reported externally.
- A company should not use the reporting practices of competitors to justify reporting fewer segments, because that results in lowest-common-denominator reporting.
- Although users generally find information about geographic segments less useful than information about industry segments, geographic segment data should be reported when it provides insight into the opportunities and risks facing the company. However, the fact that management does not use geographic data to manage the business may suggest that it need not be reported externally.

Aligning internal and external reporting also can help determine the information to be reported about each segment. For example, when reporting about each segment, companies should avoid arbitrary allocations made solely for purposes of business reporting. Instead, companies should report information in the same way they determine it for internal reporting and disclose the methods used. Companies also should disclose more detailed financial information about each investment in, or affiliations with, an unconsolidated entity that is individually significant.

2. **Address the disclosures and accounting for innovative financial instruments.**

   Business reporting has not kept pace with the continuing explosion of innovative financial instruments such as swaps, compound options, swaptions, caps, floors, collars, and many others. As a result, users are uncertain about companies' involvements with these instruments and complain that business reporting is not answering the questions they need answered such as: What is the company's objective in using innovative financial instruments? What is the company's policy with respect to hedging certain risks? What instruments has the company entered into and what are their terms? How has the company accounted for those instruments, and how has that accounting impacted the financial statements? What risks has the company transferred or assumed?

3. **Improve disclosures about the identity, opportunities, and risks of off-balance-sheet financing arrangements and reconsider the accounting for those arrangements.**

   Users are concerned that they do not understand the risks resulting from certain transactions and arrangements that, under current accounting rules, are not reflected in the financial statements. Those transactions and arrangements sometimes involve long-term leases, special purpose entities, joint ventures, securitizations, and long-term purchase agreements, to name a few.

   Standard setters should address disclosures and accounting requirements for off-balance-sheet financial arrangements to ensure that business reporting faithfully reports the risks, opportunities, resources, and obligations that result from those arrangements, consistent with users' needs for information.

4. **Report separately the effects of core and non-core activities and events, and measure at fair value non-core assets and liabilities.**

   Users analyze trends and relationships in historical financial information to predict future earnings or cash flows. To refine that analysis, they often adjust the historical amounts to exclude the effects of unusual and nonrecurring activities or events (non-core effects) as well as interest charges. Without adjustment, non-core effects can distort or mask an important trend or relationship in the company's ongoing business. A company's core activities—usual and recurring events—provide the best historical data from which users discern trends and relationships and make their predictions about the future.

Specifically, management, which is closest to the business, should quantify and display separately the effects of core and non-core activities and events on the face of the income statement, balance sheet, and cash flow statement. The notes to the statements should describe the specific transactions and events in the non-core category and the effects of each. Non-core assets and liabilities should be measured at fair value, which is more useful to users than measuring at cost those assets and liabilities that are not part of the ongoing business. The current model for measuring core assets and liabilities should be retained.

"I totally concur with the emphasis on segment reporting. And I like the emphasis on fourth-quarter reporting and the distinction between core and non-core activities. The Committee is right to raise these issues."

JEAN HEAD SISCO
Director of several corporations

5. **Improve disclosures about the uncertainty of measurements of certain assets and liabilities.**

The amount of cash on hand at a balance sheet date may be known precisely, but an accrued liability for environmental cleanup costs may be very imprecise. Users want to understand better the uncertainties inherent in certain measurements to make better judgments about earnings, cash flow, opportunities, and risks.

Because measurements often differ in their precision, companies should identify in financial statement notes the specific types of assets and liabilities subject to significant measurement uncertainties. For those assets and liabilities, companies should disclose how the reported amounts were derived and explain the estimates, assumptions, and judgments considered in their measurement.

6. **Improve quarterly reporting by reporting on the fourth quarter separately and including business segment data.**

Many users rely heavily on quarterly reporting to provide an early warning of changes in a company's business. Currently, many businesses that report quarterly do not report on the fourth quarter separately; instead, the annual report follows the third-quarter report. While users can separately derive fourth-quarter financial amounts from annual and quarterly reports, they would benefit from separate fourth-quarter reporting, including management's analysis of fourth-quarter activities and events—especially year-end adjustments—to provide continuity and additional insight.

Because many users analyze companies quarter by quarter and business segment by business segment, quarterly segment reporting is as important as annual segment reporting. The benefits are the same—better insight into opportunities and risks, and sharper predictions.

7. **Other recommendations related to financial statements.**

Standard setters should defer attention to issues that have low priority according to current evidence of users' needs. Focusing on users helps identify high-priority areas for improving business reporting. A less apparent

"We are impressed by the breadth of user involvement in the Committee's work and the Committee's genuine interest in users' needs for information. We appreciate the resulting emphasis on balance between costs and benefits, for large and small preparers and for public and private capital providers."

ACCOUNTING POLICY COMMITTEE
THE ROBERT MORRIS ASSOCIATES
(The Association of Bank Loan and Credit Officers)

benefit is the insight it provides about areas that are less important. The Committee's study identified five such areas that standard setters should not devote attention to at this time:

- **Value-based accounting model.** While many users support disclosures of fair value information, particularly about financial instruments, they generally oppose replacing today's historical cost-based accounting model with a fair value accounting model.
- **Accounting for intangible assets, including goodwill.** While users would welcome improvements in disclosure about the identity, source, and life of a company's purchased or internally generated intangible assets, they generally oppose recognizing internally generated intangible assets in financial statements. Some observers have criticized the accounting for purchased goodwill. They suggest that purchased goodwill be expensed upon acquisition or charged directly to equity. The Committee's study indicates that users do not agree on this issue and can accept current practice.
- **Forecasted financial statements.** In general, users do not expect management to provide forecasted financial statements. They are concerned about the reliability of the information and believe that forecasting financial performance is a function of financial analysis rather than business reporting.
- **Accounting for business combinations.** Some users prefer the purchase method, some prefer the pooling method, and others accept the current practice of distinguishing between the two methods. Regardless of users' views, however, the existence of two methods is not a significant impediment to users' analyses of the financial statements.
- **Alternative accounting principles.** In certain areas, such as accounting for inventories and depreciation, companies have a choice of accounting principles. Although, in concept, reducing the number of choices would improve comparability of information, as a practical matter the current flexibility is not a significant impediment for users' analyses, provided that the methods used are disclosed.

Standard setters should search for and eliminate less relevant disclosures. Over time, the cumulative effect of disclosure standards has resulted in a significant increase in the volume of information disclosed. Expansion in business reporting generally has been appropriate, given the benefits from improved reporting and the increased complexity of business transactions. However, certain disclosures, such as those introduced to educate users about the mechanics of a new standard, no longer may be necessary after the standard has been in place for a period of time.

Standard setters and regulators periodically have reconsidered and deleted less useful disclosures. They should continue and expand the review process to consider the package of disclosures now required, with a goal of eliminating those that do not communicate important opportunities and risks. Users would support such a review, particularly if the elimination of less relevant disclosures made room for more useful information.

IMPROVE AUDITOR INVOLVEMENT

1. **Allow for flexible auditor association with business reporting, whereby the elements of information on which auditors report and the level of auditor involvement with those elements are decided by agreement between a company and the users of its business reporting.**

   Users' needs for auditor assurance differ depending on circumstances such as the size of the company, its perceived riskiness, experience, and comfort with management and the sources of capital. Some would limit auditor reporting to the financial statements, while others would extend auditor reporting to other elements of business reporting. Some want an audit—the highest level of assurance—whereas others might accept a lower level of assurance, such as a review, or no assurance at all. Customized audit reporting is necessary to meet the diversity of assurance needs.

   The costs of providing auditor assurance also differ. Cost differences largely explain why the marketplace accepts review reports or no assurance on some financial statements rather than demand audit reports for all. Differences in the costs of auditor involvement obviously affect the cost/benefit trade-off considered by users and companies.

   Adoption of the Committee's model could significantly affect both the perceived need for auditor involvement and the costs of that involvement. The Committee is not recommending required expansion of auditor involvement with business reporting. Rather, it recommends a flexible approach whereby the extent of auditor association with elements of business reporting is tailored to the particular circumstances, as decided by the parties, including regulators, affected by the cost/benefit trade-off.

2. **The auditing profession should prepare to be involved with all the information in the comprehensive model, so that companies and users can call on them to provide assurance on any of the model's elements.**

   Auditors do not currently report on certain information in the Committee's model because that information is not derived from the accounting records and is more subjective than the information on which they now report. Reporting on the various elements of the model, if requested, would require new auditing standards and, possibly, new skills or additional training for auditors.

3. **The newly formed AICPA Special Committee on Assurance Services should research and formulate conclusions on analytical commentary in auditors' reports within the context of the Committee's model, focusing on users' needs for information.**

   While many users support expanding auditor reporting to include some form of analytical commentary (e.g., on audit scope and findings, accounting principles, and risks of realizing assets), opinion varies regarding areas of commentary emphasis. More research is required to determine the extent of users' needs for commentary, particularly in the context of the Committee's model, and to evaluate the barriers to, and implementation concerns about, providing commentary.

4. **The profession should continue its projects on other matters related to auditor association with business reporting.**

   During its study of users' needs for information, the Committee gathered useful information about reporting on internal control, concerns about credibility of business reporting and pressures on auditor independence, and responsibility for detecting fraud. The AICPA and others have major projects under way specifically addressing those areas. To avoid duplication of effort and to focus its efforts on areas not being addressed, the Committee excluded those areas from the scope of its work. However, it supports work in those areas and has forwarded what it learned from users to the respective organizations. The Committee recommends that those organizations consider what the Committee learned in forming their recommendations.

FACILITATE CHANGE

The reporting environment will determine the direction and pace of change in business reporting. Although the U.S. reporting environment is not flawed fundamentally, it is not necessarily favorable to the kinds of changes needed. The following recommendations address the change process.

1. **National and international standard setters and regulators should increase their focus on the information needs of users, and users should be encouraged to work with standard setters to increase the level of their involvement in the standard-setting process.**

   The FASB puts users' needs at the center of its conceptual framework, and the rhetoric of standard setting has for years featured the information needs of users. Yet standard setters rarely evaluate reporting quality directly with users. In contrast to the plentiful input standard setters receive from auditors, companies, and others, input to the standard-setting process from users is minimal. Because of their expertise about the usefulness of information in the decision-making process, users can be particularly helpful to standard setters in making agenda decisions, understanding the relative benefits and priorities of proposals, and weighing costs and benefits.

   Standard setters should add more users to standard-setting boards, advisory councils, and task forces. They also should aggressively search for, sponsor, and undertake research about how users make decisions and about the relative usefulness of various types

"We are impressed at how the Committee listened to what users had to say. The Committee carefully catalogued the existing literature on users' needs, but, more important, it also sought the information it needed directly from users themselves. If capital is to be allocated efficiently within our economy, all financial statement users, including those who manage financial capital and make markets, must be as well informed as possible."

FINANCIAL ACCOUNTING POLICY COMMITTEE
Association for Investment Management and Research

of information in the decision-making process. Users should be encouraged to speak at public hearings, write comment letters, and participate in field testing of ideas.

2. **U.S. standard setters and regulators should continue to work with their non-U.S. counterparts and international standard setters to develop international accounting standards, provided that the resulting standards meet users' needs for information.**

Differences in economies, regulations, and culture have resulted in diverse business reporting practices among nations. That diversity impairs users' ability to compare companies—a key goal of financial analysis—and adds risk and complexity to the process of allocating capital to companies in different countries and on different securities exchanges.

Consistent international reporting standards applicable to companies around the world would be helpful, provided that they meet users' needs for information. They would improve comparability and level the playing field for companies, securities exchanges, and users. Although difficult, developing high-quality international standards is a worthy challenge.

Unfortunately, past international standards have permitted wide flexibility or have reduced the information requirements to reach agreement among countries participating in the standard-setting process. If forced to choose, national standard setters and regulators should not sacrifice users' needs for information for the sake of harmonization.

Focusing on the information needs of users, rather than choosing from among existing standards and practices of countries participating in the standard-setting process, offers a promising new approach. Users' needs for the types of information in the Committee's model of business reporting may not differ fundamentally depending on the country in which the user is located. If similar, those information needs offer a common framework that standard setters and regulators from all countries can look to in setting international standards.

3. **Lawmakers, regulators, and standard setters should develop more effective deterrents to unwarranted litigation that discourages companies from disclosing forward-looking information.**

Forward-looking information that, with the benefit of hindsight, failed to accurately foretell the future is an easy target for lawsuits that are filed routinely against companies whose stock prices have fallen. Because of this, managements see disclosure of forward-looking information, even though helpful to users, as providing ammunition for future groundless lawsuits that negatively affect the dissemination of forward-looking information. Many users also are concerned that unwarranted litigation is discouraging companies from disclosing useful information.

Certainly, the right to sue for recovery for legitimate claims must be preserved, but the current system is out of balance and is undermining business reporting by depriving users of useful information. To encourage

"On balance, a very good project. The financial community has been discussing these issues for some time. These recommendations certainly are needed."

CHARLES A. BOWSHER
Comptroller General of the United States

more disclosure, lawmakers and regulators should create more effective safe harbors related to forward-looking information and adopt other measures that would discourage unwarranted litigation. Also, when developing standards related to forward-looking information, standard setters should include provisions that reduce the chance of litigation, where possible, by, for example, being specific enough to enable companies to demonstrate compliance with requirements.

4. **Companies should be encouraged to experiment voluntarily with ways to improve the usefulness of reporting consistent with the Committee's model. Standard setters and regulators should consider allowing companies that experiment to substitute information specified by the model for information currently required.**

   Some voluntary efforts to improve reporting have met with success. For example, companies and analysts have worked together to improve reporting by specific companies through the AIMR's annual rankings of public-company reporting. Experimentation with the Committee's model could accelerate improvements during the period when standard setters and regulators consider these recommendations, as well as provide information about costs and benefits. Successful experiments also could be convincing in demonstrating that practical, cost-effective improvements are possible.

5. **Standard setters should adopt a longer-term focus by developing a vision of the future business environment and users' needs for information in that environment. Standards should be consistent directionally with that long-term vision.**

   Standard setters seldom receive input on longer-term issues, and their activities tend to focus on the day-to-day business of more immediate issues. A vision of users' needs for information in the business environment of the future would help standard setters identify truly important projects, provide a means to evaluate potential standards, and improve the chance of anticipating problems rather than reacting to crises.

   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, accounting, 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.

"I view the report as a beginning and not the end. Financial reporting is continually evolving. There should be a standing committee of this type."

BARUCH LEV
Professor of Business Administration
School of Business
University of California, Berkeley

The Committee was aware that studying the information needs of users was crucial, but not enough. Not only will users' needs change over time, but also there may well be new types of users in the future. For this reason, the Committee studied the effects on users, and their needs, of likely changes in the technological, economic, social, and political environments over the next ten years. Then the Committee tested its tentative recommendations against these projections for consistency with, and responsiveness to, longer-term trends. The result was added confidence in the recommendations in this report and a strengthened conviction that continuous improvement in business reporting will be required to meet the continuously changing needs of users.

6. **Regulators should consider whether there should be any changes to the current requirement that public companies make all disclosures publicly available.**

The inherent tension between a company's "need for confidentiality" and the users' perceived "right to know" is an important issue to address in developing a longer-term vision of business reporting. Many expect that tension to increase in the future. On the one hand, the increased availability of information, the increasing complexity of business transactions and relationships, and users' expectations for more information will provide pressure to disclose more information. On the other hand, a public company's competitors have access to the information it discloses to users, and the cost of disclosing more competitively sensitive information can be prohibitive, even if that information would help users allocate capital more effectively.

The requirement to disclose the same information to all users has resulted in a more level playing field for users in the public capital markets. However, in the future, the cost of reporting sensitive information to competitors could become an unnecessary barrier to providing the most useful information to users and allocating capital most effectively.

The Committee is not recommending that the uniform disclosure requirement be abandoned. However, regulators should consider whether there are ways to reduce competitive costs of disclosure by shielding certain information from competitors.

The Challenge of Change

Companies everywhere are learning that change, although tough, is essential to survival. Process reengineering and continuous improvement are becoming a way of life for many. They are managing for change by building it into their thinking and processes. Indeed, many are using change to their strategic advantage. Business reporting, like business itself, must change to survive, to keep pace with evolving needs for information, and to support the capital allocation process.

The changes called for by the Committee's recommendations will require a supportive regulatory, business, and legislative environment. Thus, the Committee is pleased that the AICPA Board of Directors has established a coordinating committee to assist all constituents involved in the standard-setting and reporting processes in seriously considering the Committee's recommendations and planning for change in business reporting.

The Comprehensive Report and Database

In addition to this brochure, the Committee has produced a comprehensive report that includes the results of its research, the basis for its conclusions, and details about its recommendations. It also includes the Committee's business reporting model and an illustration of that model applied to a fictitious company.

The Committee also has built a substantial (1,600-page) database of its research on the information needs of users that includes source information and the analysis of it.

Copies of the comprehensive report and the database, as well as additional copies of this brochure, are available from the AICPA.

Order Information

For pricing information and to order copies of the reports, contact the AICPA Order Department:

–Comprehensive Report, Improving Business Reporting—A Customer Focus *(print version #019303, available late fall). (Members of the AICPA may receive, at no charge, one copy of the print version of this report by writing to the Institute at the address below.)*

–Database of Materials on Users' Needs for Information (print version #019306).

-Additional copies of this brochure (#019305).

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