CONFLICTS AND COMPROMISES IN FINANCIAL REPORTING

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Business operations are complex, continuous and based on future oriented decisions. Financial statements are simplistic, based on a trading model developed in the middle ages, prepared for discrete segments of time, and attempt to the extent possible to ignore the future in favor of the past. It is small wonder, therefore, that financial statements have their critics in today's world. It is perhaps more surprising that they still have a group of loyal followers.

It seems inevitable that over the next decades we will see financial statements and more generally, financial reporting, move in the direction of the world as it exists. This trend is already in evidence but only in a relatively prenatal form. Nevertheless, these fundamental discrepancies have given rise to substantial conflicts in the world of financial reporting. Today, I would like to address myself to a number of these conflicts and give my views as to the compromises which are likely to take place in resolving them.

Simplicity vs. Complexity in Financial Reporting

For many years the primary goal of accountants has been to produce the perfect income number which will describe opertions realistically and understandably. They have been encouraged in this search for Truth by analysts and other users of financial statements who have placed substantial emphasis on earnings per share as an easy handle in interpreting corporate performance. Many of these accountants view today's trends toward more extensive disclosure with some suspicion and prefer to devote their efforts to the continuing arguments about the measurement of income. They are particularly concerned about attempts to require disclosure of the impact of alternative accounting principles which they view as impugning the integrity of published financial statements.

While we all, of course, long for simpler times, I believe that it is unlikely that this quest for accounting Truth will prove successful, or even particularly useful. We should not encourage those who look for the easy handle to describe a complex world. There are greater dangers in the over-simplification of a complex reality than there are in "information overload." You simply cannot find one number, or even a few numbers which accurately summarize the business operations of a multi-national, multi-billion dollar conglomerate enterprise employing thousands of people and distributing multiple products. The attempt to do this is likely to lead people to false perceptions rather than to understanding. If accounting is to describe an increasingly complex world, it is an unfortunate necessity that accounting itself become more complex.

It is generally recognized that internal information systems today have become highly sophisticated. Such systems are characterized by frequent reporting and a considerable amount of information available on a real time basis. They include provision for great detail availability which also providing for summarization and analysis for senior managers, and they have an orientation in the direction of managerial decision making.

Computers have made is possible to develop modular information systems meeting many purposes. While it is fair to say that the potential of information technology has not yet been fully utilized, there have been dramatic improvements in internal financial information. These characteristics of internal information, however, have not yet moved into public financial reporting, although there have been some preliminary steps in this direction. In the long run, it seems unlikely that the benefits of improved information will be denied to the users of external reports.

One of the principal characteristics of any reporting system is that it must communicate to the users of the reports. This is true of both internal and external financial reporting. While it is essential that accounting communicate, the goal of communicating effectively to an unsophisticated lay reader will continue to be elusive. In order for a user to receive a message he must be able to speak the same language as the communicator. This means first that the must have an understanding of the business enterprise and second, that he must have some knowledge of the accounting model which is the basis of the language used. To seek a single number that can be understood by a casual reader is to pay too high a price in terms of reality. In order to achieve such simplicity, too much information must be given up.

In today's world, the most important user of financial information is the sophisticated analyst with the time and background to study and comprehend the results of economic activities. Many of the disclosure requirements of recent years, therefore, have been specifically developed for this user. This approach does not mean that the individual investor is being discriminated against. The data used by the sophisticated analyst are available to all, and the Securities and Exchange Commission has made a great effort to prevent the distribution of insider information on a discriminatory basis. To suggest that all users should be denied sophisticated information because its effective use may discriminate against the less well trained user is to take a position contrary to the underlying philosophy of both our economic system and the securities laws. In addition, if one assumes there are a significant number of sophisticated analysts in the marketplace, it seems very likely that all this information will be reflected in the price of the security, and hence the small investor seems likely to have a fair price, even though he may not have the capability to analyze sophisticated data. In a sense, he receives the benefit of the analysis of others.

In addition, financial reports should include better summaries and financial analyses which indicate management's judgment as to what items are of the greatest importance in understanding results of operations and the financial position of an enterprise.

The final compromise, therefore, seems to be movement in the direction of what has been called differential disclosure, recognizing the differing objectives, training and time availability of users. Given management's obligation of presenting a "true and fair view," the financial statements must of necessity move in the direction of greater detail and complexity. They must be supplemented by additional data which supply greater detail of those who desire it and by improved summaries and analyses which present an interpretation for those who do not or cannot develop at their own interpretations.

Discrete vs. Continuous Reporting

The second major conflict which exists in financial reporting is between the continuous nature of business operations and the discrete periods involved in the normal presentation of accounting data. Accounting originally covered the entire life of a commercial venture, such as a merchant's voyage. As business became a continuous process, however, without any defined life, it became necessary to devise a series of progress reports which would reflect the activities of the enterprise. In the interests of consistency, a period had to be agreed upon which would be used on a regular basis by all enterprises. Because many human and business activities relate to the length of time it takes the earth to circle the sun and because that period was well known, it was the one selected. The arbitrary selection of any period made it necessary for the accountant to devise conventions for the allocation of amounts to each period when transactions affected more than one.

In a sense, accountants have been too successful in this process. The year has assumed an importance as a reporting period to the extent that it is sometimes forgotten that it is only an arbitrary segment of a business continuum. Analysts and managers alike have emphasized results for the year. In a number of cases, business and accounting decisions have been made with the objective of reporting favorable results for a year in spite of detrimental long-term results for a business. The management of a business cannot be focused on annual reported earnings if shareholder benefits are to be maximized in the long run. Sound management must recognize the continuous nature of operations.

This suggests that accounting and financial reporting must also move in the direction of becoming a continuous process. There are a number of elements involved in such a movement. The first requires a change in the reporting "state of mind." Reporting must be viewed by management both as an integral part of its managerial task and as an on-going responsibility, not one that must be faced only once a year when the annual accounts are prepared. As business events accrue and business decisions are made, their impact should be reported on a timely basis. This, of course, does not mean that every sale should be publicly reported, but that anything which has a significant impact on the direction a business will take, or which results in a significant change in business expectations, should be reported promptly.

A second element in continuous reporting is the development of more frequent reporting of results and financial position. Users of financial information will be better able to understand the way in which a business operates if they receive frequent reports about it. More frequent snapshots present a better ongoing view than do less frequent but more elaborately constructed pictures. It is worth remembering that "motion pictures" are in fact the rapid showing of frequent sequential still photographs. Financial reporting should aim for a similar effect.

It must be emphasized that the move in the direction of more frequent reporting is not an attempt to substitute an even shorter and more arbitrary period such as the quarter for the year, nor is it designed to put increased emphasis on quarterly earnings per share figures. Rather, by providing additional quarterly information beyond simply net earnings, it is intended to assist users in putting quarterly earnings data in prospective and to show more clearly the changing patterns of asset and liability structure and cash flows.

The third element of a continuous reporting system requires that all periodic data reported be placed in the context of the business continuum. Any period is a discrete segment of a total business life, and the disclosures made for that period must recognize this fact. Relationships to the past and to the future must be identified, and the significance of past activities and future expectations in the results reported should be made explicit. This requires the use of analyses of the data, articulation of the assumptions underlying its preparation and the presentation of future expectations in a systematic way.

The Securities and Exchange Commission has recently expanded substantially its interim reporting requirements so that all registrants must provide condensed quarterly financial statements and an analysis of the changes that have taken place from quarter to quarter. In addition, the Commission and the accounting profession have taken steps to encourage the involvement of auditors in the interim reporting process on a limited review basis, and the Financial Accounting Standards Board has recently put on its agenda the accounting problems of interim reports, so activity in the USA on this topic is substantial. Elsewhere, less is being done in this regard, but as better data becomes available in the USA, it seems likely that users of statements elsewhere will begin to demand similar information.

<u>Past-Oriented vs. Future-Oriented Disclosure</u>

Another source of conflict over the objectives of financial reporting centers on the question of whether it is primarily designed to report on management's past stewardship over the assets entrusted to it or whether it is oriented toward investment decisions which are essentially future-oriented. Fortunately, these are not mutually exclusive alternatives since data regarding the past is one of the building blocks needed to predict the future, but there is a difference in emphasis which may lead to alternative choices among reporting alternatives.

The Trueblood Committee report on the objectives of financial statements came down squarely on the side of future-oriented reporting. It indicated that the principal objective of reporting was providing information for those making investment decisions and it clearly identified the investor's need with the future. Since the S.E.C.'s statutory mandate is the protection of investors, it is not surprising that the Commission has taken recent initiatives in this same direction. The legal framework for financial reporting around the world, however, generally emphasizes accounting for management stewardship. Under most companies acts, the directors report to the stockholders. It is only under the securities laws of the United States that the potential stockholder has the same right to information as the current stockholder. This may suggest a different answer to the problem of when to make disclosure under conditions where public disclosure may have an adverse effect upon current shareholders.

In examining future-oriented disclosure, it is important to understand that far more is implied than simply the publication of projections and forecasts. The most important parts of such a disclosure framework comprise appropriate breakdown and analyses of historical data and the presentation of presently existing factual data which may have a significant impact on the future.

Historical financial statements, for example, should be presented in such a way as to permit users to understand the sources of earning power and the degree to which past results may reasonably be expected to be repeated. This requires the breakout and separate identification of unusual and nonrecurring transactions, and the presentation of the different lines of business in which an enterprise is involved. In addition, information regarding a firm's dependence on a single customer or a single market would assist investors in assessing risk.

Data outside the financial statements also may be important. Order backlogs may be particularly significant, as may reports on the progress of long-term contracts, commitments, research developments, market shares and cost behavior.

Another key element in future-oriented disclosure is the development of current cost accounting approaches. Presumably data based on the current economics of business is more useful in reaching informed judgments about the future than is historical cost data. This is one of the underlying reasons for the Commission's recent decision to require the disclosure of certain replacement cost information in notes to the financial statements. In an inflationary environment, the reduced relevance of historical cost is being recognized around the world. The Commission's rule is the first adopted requirement for replacement cost data, and it will mean that 1976 financial statements of large U.S. companies will include this information. An Advisory Committee made up of representatives of industry, the accounting profession, financial analysts and academics is now at work to assist the Commission staff on the problems of implementation associated with the rule. I am particularly pleased that the Chairman of the Inflation Accounting Steering Group in the U.K. is a member of the Advisory Committee to be certain that the Commission's efforts are coordinated with the important work going on in the U.K. to implement the Sandilands Report.

This Advisory Committee will be considering conceptual and empirical problems associated with particular factual situations, and it will also be devoting attention to the most meaningful methods of presentation of the required data and any supplemental information the registrant deems appropriate. In many cases, the way in which the data is presented and explained will be of greater importance to understanding its future implications than will the numbers themselves. I hope that in the development of improved disclosure approaches, we will be able to assist in achieving more future-orinted information.

It should be emphasized that the S.E.C. has not proposed to change the basic financial statements, nor to abandon historical cost. We believe that we have taken a meaningful step in the direction of providing information of significant predictive content to investors, but we are not prepared to change the fundamental accounting model. This should be done, if at all, by the Financial Accounting Standards Board after a careful study of all the issues.

A final element of future-oriented disclosure is the development of projections and forecasts. Since management is the closest to business activities, its expectations about the future are important information for investors. In addition, these expectations provide a framework within which the present can be more meaningfully interpreted. Clearly, changing current results which have the effect of changing managerial expectations are more significant than changed current results which have no impact on future expectations. Since virtually all management information systems contain forecasts and projections, there would be no major data gathering cost in presenting them to investors. Management information systems also analyze variations from expectations. Disclosure of such an analysis would communicate the risk characteristics of the business. In a recent release the Commission proposed a permissive approach to projections, and the following observation was made:

> "In weighing the advantages and disadvantages of disclosing projections and in determining the period and format of projections, management should not be guided solely by its ability to forecast a single net income figure. Investors may be provided with useful information by the presentation of ranges or alternative estimates based on various assumptions about future events. In addition, an important benefit from such disclosures may arise from the systematic analysis of variances between projected and actual results on a continuing basis, since such disclosure may highlight for investors the most significant risk and profit sensitive areas in a business operation."

This emphasizes that projections and forecasts should be viewed as another element in the mosaic of information which must be put together in making investment decisions, but not as a statement of what next year's income will be.

From these remarks, it should be apparent that my view is that financial information should be viewed as future-oriented and designed for the use of investors in decision making, rather than for stockholders reviewing the stewardship of management. Nevertheless, it would appear possible to accomodate the requirements of stewardship accounting in an investor-based system since an accurate accounting of the past is part of the data needed by investors. In developing legal requirements based on the stewardship concept, it is important that constraints not be placed on the data presented which inhibit companies from meeting the needs of investment decision makers.

<u>"Hard" vs. "Soft" Data</u>

A fourth conflict which is becoming increasingly apparent is that between data which is objective and precise on the one hand, and that which is subjective and interpretive on the other. Historically, financial reporting was dedicated almost exclusively to hard data, following the tradition of the TV detective who liked to state that all he wanted was "just the facts." As we move in the direction of complex, future-oriented and continuous disclosure, however, it becomes apparent that elements of objectivity must be sacrificed. Accountants and investors must develop a greater tolerance for imprecision and subjectivity, recognizing that interpretive judgments are required both by managers and by independent auditors involved in the reporting process.

This is not an easy step. Accountants have long sought the comfort of certainty and they find it difficult to deal with subjective judgments and ranges of possible outcomes. In addition, the legal environment in the United States places a substantial burden on those who have responsibility for public financial disclosure.

One approach that has been taken is to make the basic financial statements as verifiable as possible through the creation of more specific rules of presentation, while putting subjective and interpretive data outside the statements. This is a dangerous path to take, however, since it runs a high risk that financial statements will increasingly become a legal ritual rather than a source of economic information about business operations.

A more promising step might be taken through the inclusion of recognition of uncertainties and the need for interpretation in the standards of the profession, and recognition of these standards in regulatory and judicial environments. At the present time, however, the fear of legal liability seems to be dominating the development of professional standards in the United

States, and efforts in the direction of expanding responsibilities to include subjective and interpretive data are moving slowly, if at all.

Comparability vs. Flexibility in Setting Accounting Principles

A fifth conflict is an old one: the choice between comparability and flexibility in the selection of accounting principles. Like so many other issues, the right answer depends on the question which is asked. Few people would answer affirmatively to the question "Do you want rigid and inflexible rules which would apply mechanistically to the preparation of financial statements, regardless of variations in the factual circumstances?" Similarly, few would respond affirmatively to the suggestion that each management should select the principles by which their company should be measured, regardless of the need for comparability by investors.

It is evident, therefore, that we need standards of measurement that will treat enterprises seeking investors' funds in the marketplace in an equal fashion, so that their reported results are comparable. On the other hand, these standards must recognize the need for differing treatment of differing factual circumstances and thus not lay down rules so rigid as to force unlike entities into the same reporting. This is the challenge for all standard setting bodies, and it is not an easy one. Every enterprise views itself as unique, and indeed to some extent it is. At the same time, elements of similarity must be recognized. The standards of measurement must be the same in similar circumstances, since it is only logical that all enterprises have the same method of keeping score.

I hope that an appropriate compromise in this difficult area will be provided by the development and articulation of a general accounting measurement model by the Financial Accounting Standards Board, combined with the development of specific standards which recognize different classes of factual circumstances rather than applying a simple standard to all situations where a particular accounting problem arises.

Reporting to Meet Investment Objectives vs. Other Objectives

A final conflict which is receiving increased attention is that between those who feel that corporate reporting should be entirely oriented to investment decisions and those who feel that it should reflect many other interfaces between the entity and society. The S.E.C., for example, is currently involved in litigation brought by groups who feel that our disclosure requirements are not sufficiently responsive to those whose concerns relate primarily to the environment and to equal employment opportunity. While we believe that our statutory obligation is limited to the interest of investors, it is not clear that corporate reporting in general can take such an approach. The diverse conclusions of the Trueblood Committee report which adopted a broader view of the objectives of financial statements are indicative of the concerns now abroad in the reporting world.

This is not an issue which can be fully addressed in this paper, but I think it is apparent that some compromises are necessary. It is simply not practical to meet the needs of all those who have any interest in any aspect of corporate activity through the use of a simple or single report. It may not be possible to meet some desires for information within the framework of an economic system based on business competition. Eventually, it seems likely that a modular system of information and reporting will be developed that will allow those with different skills to specify the information package which is most relevant to their needs. If some data were made available on a cost reimbursement basis, users with unusual needs would find it necessary to determine the value of information to them. This would probably be a healthy exercise, and may be the ultimate expansion of "differential disclosure."

Conclusion

I have attempted today to sketch some trends and directions in financial reporting through the analysis of some basic conflicts which currently exist. The existence of such conflicts is healthy, since it suggests that we have a dynamic reporting system which is responsive to changing demands. Through the joint efforts of the accounting profession, corporate executives and diverse users of corporate reports, I am confident that we will be able to find continuing compromises which will resolve not only today's conflicts, but those which arise in the future as well.