

# A Comprehensive Business Reporting Model

*Financial Reporting for Investors*

24 October 2005



# **A COMPREHENSIVE BUSINESS REPORTING MODEL: Financial Reporting for Investors**

**CFA Centre for Financial Market Integrity**

**DRAFT**

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# Chapter 1. Why Does Financial Reporting Matter to Investors and Investment Professionals?

*It is unfortunately true that less than half of our important enterprises supply this very moderate quota of information. Withholding of data—particularly of annual sales—is usually justified on the ground that it might be used by competitors or customers to the detriment of the company and therefore of the shareholders. Such assertions are rarely convincing, especially since they are contravened by progressive managements in every line of industry.*

Benjamin Graham and David Dodd<sup>1</sup>

## Introduction

The business reporting model is the lens through which investors perceive the wealth-generating activities of a company and the results of those activities. The model will succeed or fail based upon its capacity to communicate these activities clearly and completely. Businesses continually evolve, entering or leaving markets, developing new products and services, and finding new ways to attract and retain customers. These changing business practices require that the business reporting model evolve as well so that it can always meet investors' needs for the information required to evaluate investments and make financial decisions.

We believe that opportunities exist for making significant improvements in the financial reporting model. In the chapters that follow, we propose changes that must be made to enhance the usefulness of the current reporting model, particularly for the benefit of investors. A summary of our 12 proposed principles, current practices, and the reasons why reforms are necessary is provided in Exhibit 1 on page 4. We recognize that these changes must be made in an orderly fashion, and some will take many years to realize, as standard setters gradually revise the reporting standards. But some changes—including our recommendations for improvements to the way currently available financial information is presented in the financial statements—can be made in the near term. Other near-term improvements include full fair value reporting for all financial instruments, fair value reporting for the consolidation of acquisitions and off-balance-sheet financial activities and obligations, on-balance-sheet fair value reporting of all lease transactions (both assets and liabilities), and on-balance-sheet fair value reporting for defined-benefit pension plans.

Since 1934, when Graham and Dodd first published their classic text *Securities Analysis*, the practice of investment analysis and valuation has been virtually synonymous with what it means to be an investment professional. We serve our investing clients and, ultimately, the financial markets, by assessing the risk and value of an investment opportunity and evaluating its suitability for each client's particular circumstances. Whether this process leads to valuation of an entire company, a specific equity, a fixed-income security, or a derivative security, the goal of analysis must be to provide a reasonable and adequate basis upon which to make an investment recommendation to clients or to take an investment action on their behalf.

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<sup>1</sup>Graham, Benjamin, and David Dodd, *Securities Analysis*, Whittlesey House/McGraw-Hill, 1934. Graham and Dodd refer to the following income statement items: (1) sales, (2) net earnings (before the following), (3) depreciation and depletion, (4) interest, (5) nonoperating income (in detail), (6) income taxes, (7) dividends paid, and (8) surplus adjustments (in detail).

In order to become an investment analyst and, in particular, to hold the Chartered Financial Analyst® designation and be a member of CFA Institute<sup>2</sup>, we must hold ourselves accountable to standards of competence and conduct.<sup>3</sup> These standards require us, as analysts and investment professionals, to act with integrity and to strive to improve our competence and that of our profession. The ability to make high-quality, independent, objective, and reliable investment decisions depends not only on our expertise in the use of analytical and valuation techniques but also on the quality of the information available for us to collect, analyze, and incorporate into our valuation models.

Because corporate financial statements are the primary source of the information we require for our analyses, we must encourage the highest quality in financial reporting principles and standards and work with standard setters to achieve these objectives. Our goal is to ensure that financial statements and their accompanying disclosures provide all the information we need in a readily accessible and useful form. We believe that the current financial reporting model should be improved. We intend to contribute to this effort.

Investors require timeliness, transparency, comparability, and consistency in financial reporting. Investors have a preference for decision relevance over reliability. Unfortunately, on occasion, lack of reliability is still used as an excuse to withhold information. As CFA Institute stated in 1993 and will reiterate in this paper, “analysts need to know economic reality—what is really going on—to the greatest extent it can be depicted by accounting numbers.”<sup>4</sup> Corporate financial statements that fail to reflect this economic reality undermine the investment decision-making process.

The basic issues of greater recognition and measurement, better disclosure, and increased transparency have not changed very much in the last decade. In fact, the corporate reporting scandals and bankruptcies in the opening years of this century have underscored just how little progress has been made, despite some major improvements in financial reporting standards, including reporting for stock options, derivatives, and consolidations among others. Investors still need information that companies are unwilling to provide. Although we may no longer lament the lack of sales information as Graham and Dodd did in 1934, we can replace sales with financial instruments, pensions, and other items in Graham’s quote and hear the same arguments put forward to counter investor demands for complete, transparent information.

We believe that investors will be best served if the revisions to the financial reporting model involve fundamental reforms rather than superficial, cosmetic changes. Consequently, we will work with purpose and determination to assist standard setters to address the underlying problems of an antiquated accounting model, one that was originally designed for manufacturing and merchandising companies.

Although such companies still exist and will continue to thrive, service businesses—especially those in the financial sector—constitute a major and growing portion of the global economy. Many of the largest companies worldwide are either primarily financial services businesses or derive a substantial amount of their revenues and earnings from such activities, the purchase and sale of cash, or commitments to engage in such transactions. Many companies with manufacturing or merchandising core businesses have added services to their product lines and provide customer financing from their own subsidiaries. The reporting model must be able to provide investors with the information they require to understand financial services companies and the various aspects of their operations.

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<sup>2</sup>Headquartered in Charlottesville, Virginia, USA, with offices in London, UK, and Hong Kong, PRC, CFA Institute, formerly known as the Association for Investment Management and Research (AIMR), is a global professional organization of individual members who hold the CFA designation and individual members who are active in the investment business and agree to abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Societies may also be admitted to CFA Institute membership, but are nonvoting members.

<sup>3</sup>Stowe, John D., Thomas R. Robinson, Jerald E. Pinto, Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, AIMR (Charlottesville), 2002, Ch. 1, p. 24.

<sup>4</sup>Ibid, p. 3.

Today, many companies in global markets are driven by the creation and use of intangible assets. Indeed, much of the major economic growth worldwide is attributable to such assets. The current reporting model is deficient in its requirements for transparent recognition and disclosure for these assets. Investors must have the information they need to understand, analyze, and value intangibles-dependent companies.

Investors require much more comprehensive reporting of financial statement items and the company activities and events that underlie them than is generally available. This expanded information is required if investors are to be able to evaluate company performance and understand its wealth-generating processes. These items were our primary focus in 1993 and remain so today. Disclosures are an essential ingredient in the financial reporting process. In fact, the financial statements cannot be fully understood without extensive, clear, and complete supporting disclosures. We believe that disclosures should be considered jointly with the setting of the related recognition and measurement standards. Furthermore, they should be held to the same standards of relevance, reliability, clarity, and completeness.

Finally, we strongly advocate that standard setters begin to refocus their perspectives on the development of accounting standards. Specifically, we believe that the financial statements should be viewed from the position of an investor in the common shares of the company. *Existing* common shareowners are the residual claimants in the net assets generated by a company. All other claims are superior to theirs and must be fully satisfied before common shareowners may exercise their claims. Hence, we believe that if the information needs of existing common shareowners are fulfilled, the primary needs of other prior claimants will be met as well.

Corporate financial statements and their related disclosures are critical to sound investment decision-making. The well-being of the world's financial markets, and of the millions of investors who entrust their financial present and future to those markets, depends directly on the quality of the information financial statements and disclosures provide. Consequently, the quality of the information drives global financial markets. The quality, in turn, depends directly on the quality of the principles and standards by which managers recognize and measure the economic activities and events affecting their companies' operations. To succeed, a partnership is needed among standard setters, common shareowners, and other investors to bring full transparency and the highest integrity to the standards and the processes by which those standards are developed. CFA Institute and the CFA Centre for Financial Market Integrity are committed to join in a partnership to improve financial market integrity in the 21<sup>st</sup> century.

## Exhibit 1. Summary of the Comprehensive Business Reporting Model Proposed Principles, Current Practices, and Reasons for the Importance of the Proposed Changes

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### 1. Principle: The company must be viewed from the perspective of a current investor in the company's common equity.

**Current Practice:** Financial reporting standard setters have made significant improvements in financial reporting since the early 1990s. These advances include rules requiring that all derivatives be reported at *fair value* and that all stock options granted to employees (compensation) be expensed at *fair value*. But much remains to be done. Many major claims against the company's resources (for example, pension obligations and contingencies) currently escape the balance sheet and income statement and are not fully reported in the notes. Similarly, many revenue-generating assets (for example, receivables, intangibles, and leased assets) are allowed under current rules to escape complete and clear recognition in the financial statements. (See Principle 2)

**Reasons for Importance:** The current common shareowner (CCS) is the *last* to receive a share of the company's net assets (that is, assets in excess of liabilities) and earnings. This means that the claims of *all others* must be fully satisfied before those of the CCS. Consequently, a CCS must have complete, accurate information about all other claims—including potential risk exposures and possible returns—to value his or her own investment. Similarly, a CCS must understand what assets are controlled and used by the company and the implications of these assets for the company's future growth and financial health.

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### 2. Principle: Fair value information is the only information relevant for financial decision making.

**Current Practice:** Since the early 1980s, financial reporting standard setters have tended to base new standards on fair value measurement. The FASB, working on its own behalf and that of the IASB, has developed a new standard for fair value reporting for assets and liabilities and expects to release the final standard in the fourth quarter of 2005. The CFA Centre strongly supports this effort, but the majority of standards comprising the bulk of current GAAP are not based on fair value principles. Much work remains to be done to bring these rules into compliance with the FASB's fair value standard.

**Reasons for Importance:** Decisions about whether to purchase, sell, or hold investments are based upon the fair values of the investments and expectations about future changes in their fair values. Financial statements based on outdated historical costs are less useful for making such assessments. Fair values, by definition, impound all of the most current assessments about the value of an investment and any future changes in that value.

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### 3. Principle: Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone.

**Current Practice:** Although recently developed reporting standards have tended to be designed to provide information relevant to financial decision making, many older standards, which form the bulk of current GAAP, were structured more from a concern for practicability (what was easiest to do and most easily verified) rather than from a consideration of what would constitute the most useful information. Indeed, many companies have now instituted financial analysis divisions responsible for developing the sorts of information investors require but are only used by internal managers. The role of the financial analysis team is to develop timely, fair value information so that managers will have the information they require to make their own investment decisions, for example, to acquire assets, expand or reduce operations, or divest portions of the operating activities. Although company managers may be reluctant to provide such information to investors, they recognize that the information is critical for the investment decisions that investors must make.

The CFA Centre believes that most standard setters subscribe to the idea that GAAP accounting methods must produce decision-relevant information, but much work remains to achieve this objective.

**Reasons for Importance:** Financial information may be completely reliable if it is easily verifiable according to one or more criteria. But the information may not be relevant for financial decision making. An example is the purchase by a company of a major manufacturing facility 30 years ago for which the bill of sale is available to support the recorded cost. The recorded cost may, therefore, be considered reliable in the conventional sense. Financial decision makers today, however, would find little that is useful or relevant in that number for the decisions they must make today.

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**Exhibit 1. Summary of the Comprehensive Business Reporting Model Proposed Principles, Current Practices, and Reasons for the Importance of the Proposed Changes**  
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**4. Principle: All economic transactions and events should be completely and accurately recognized as they occur in the financial statements.**

**Current Practice:** Because companies seek to portray themselves in the best light, they sometimes engage in transactions that do not require immediate recognition (such as off-balance-sheet financing). For example, despite amendments of the lease accounting rules by the FASB, many leased assets remain off balance sheet even when the company effectively owns or controls the leased assets.

**Reasons for Importance:** The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting.

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**5. Principle: Investors' wealth assessments must determine the materiality threshold.**

**Current Practice:** Despite statements of regulators, including the U.S. SEC, company managers and their auditors tend to apply *ad hoc* "rules of thumb" when deciding (1) whether certain items are of sufficient size or importance (materiality) to warrant clear, separate reporting and (2) the reporting method to be applied. For example, some managers and auditors may use as their benchmark 5 percent of a line item, such as net income or total assets or sales. In contrast, we believe that materiality assessments should use the standard of whether the item would make a difference to an informed investor. For example, a relatively small amount might change the trend of an expense category. Moreover, related items should be considered in total, rather than individually, to determine materiality.

**Reasons for Importance:** Financial statements are prepared for those outside the company who need the information and who base their financial decisions upon it (e.g., investors). Consequently, the materiality threshold should be based upon what will *affect* investors' decisions and not upon preparers' arbitrary assessments. These decisions should be based both on quantitative as well as qualitative factors. For example, even a small amount of fraud committed by company managers would likely be considered to be highly material to investors, who need to assess the integrity of those to whom they have entrusted their assets.

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**6. Principle: Financial reporting must be neutral.**

**Current Practice:** Reporting standards issued recently tend to honor this principle more faithfully than before. Examples include the recently issued FASB and IASB rules on the expensing of stock options. Many older standards, however, still exist and are applied to major categories of transactions that were heavily influenced by concern about outcomes rather than the imperative to fully report the economic essence of the items.

**Reasons for Importance:** Reporting of economic transactions and events should not be influenced by the *outcomes* of the financial reporting or the effects that the reporting may have on one or more interests. For example, in the recent stock options expensing debate, those opposed to expensing argued that expensing stock options as compensation would reduce net income, causing companies that issue stock options to reduce the number of options granted to employees, making it harder to attract talented employees. The argument was misplaced. All costs of production, including employee compensation, must be reported fairly, completely, and accurately. In the past, concern for outcomes has caused preparers to bring considerable pressure, both directly and indirectly through other political forces, against standard setters to scale back, slow, alter, or abandon standard-setting attempts altogether. One example is the reporting of defined-benefit pension obligations and the cost associated with such plans. The rule as it was initially drafted for reporting such obligations was broadly consistent with fair value recognition. But under the intense pressure of preparers, successive drafts gradually purged all remnants of fair value reporting. Under the final rule, neither the balance sheet nor the income statement reflects the economic position of the plan and changes in that position.

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**Exhibit 1. Summary of the Comprehensive Business Reporting Model Proposed Principles, Current Practices, and Reasons for the Importance of the Proposed Changes**  
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- 7. Principle: All changes in net assets must be recorded in a single financial statement, the Statement of Changes in Net Assets Available to Common Shareowners.**
- Current Practice:* Changes in net assets are not reported in a single place but are scattered throughout the financial statements, the income statement, cash flow statement, balance sheet, and statement of changes in shareholders' equity. Moreover, the extensive aggregation and netting in the financial statements make analyses to generate many of these numbers all but impossible.
- Reasons for Importance:* We believe that all such changes should be reported clearly and understandably and in a single statement. Investors must now expend great effort to locate these changes and make use of them. Indeed, because of the high levels of aggregation and the lack of consistency, investors must resort to a great deal of analysis to try to determine the source and magnitude of many changes, if they are able to do so at all.
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- 8. Principle: The Statement of Changes in Net Assets Available to Common Shareowners should include timely recognition of all changes in *fair values* of assets and liabilities.**
- Current Practice:* Relatively few statement items are required to be recorded at fair value with changes recognized currently in net income. Derivative instruments and securities held for trading are notable examples that meet this test. The rules, however, permit gains and losses for some items that currently are recorded at fair value in the balance sheet (for example, available-for-sale securities and cash flow hedges) to be deferred outside of income.
- Reasons for Importance:* If investors are to be able to evaluate how the value of their investment in a company is increasing or decreasing, they must be able to fully understand how the company's operations and activities are increasing or decreasing the values of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or wealth-consuming patterns are changes in the fair values of these assets and obligations.
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- 9. Principle: The Cash Flow Statement provides information essential to the analysis of a company and should be prepared using the direct method only.**
- Current Practice:* Only a handful of the thousands of public companies worldwide report cash flows using the direct method.
- Reasons for Importance:* Ultimately, investors value their investments by forecasting the company's future cash flows and cash flow generating ability. A clear picture of the company's current means of generating cash flows, the patterns of inflows and outflows, and its effectiveness in producing cash is essential to this analysis. The current cash flow statements of most companies do not provide this information.
- 10. Principle: Changes affecting each of the financial statements must be reported and explained on a disaggregated basis.**
- Current Practice:* The financial statements issued by most companies today, from the largest with extensive cross-border operations to very small, narrowly focused startups, tend to be highly summarized and condensed. This is achieved by adding together unlike items to report relatively few line items in the statements, despite the disparate economic attributes of their operations. A good example is the line item "miscellaneous assets," which is sometimes the largest amount in the balance sheet.
- Reasons for Importance:* Aggregation of information with different economic attributes, different measurement bases, different trends, and from very different operations results in substantial loss of information. Indeed, the information lost is essential to investors' understanding of a company's financial position, changes in that position, and the implications for valuation of investments.
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**Exhibit 1. Summary of the Comprehensive Business Reporting Model Proposed Principles, Current Practices, and Reasons for the Importance of the Proposed Changes**  
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**11. Principle: Individual line items should be reported based upon the *nature* of the items rather than the *function* for which they are used.**

**Current Practice:** Information in financial statements, particularly in the income statement but also to a lesser degree in the balance sheet, is aggregated in major functional categories, such as cost of goods sold and selling, general, and administrative activities. This practice began long ago when companies tended to be focused in a single industry or activity and the items aggregated were more nearly homogeneous. Such is not the case today.

**Reasons for Importance:** The forecasting of individual line items for use in valuation and other decisions requires that they be relatively homogeneous—that is, represent a single economic attribute or an aggregation of very similar attributes. For example, rather than following the current practice of aggregating labor cost, pension costs, raw materials, energy costs, overhead allocations, and the like into cost of goods sold, which mixes items of very different economic characteristics, trends, and measurement bases, the individual categories should be reported. Indeed, investors currently expend much effort to disaggregate such numbers. Because of the limited information available, the calculations require much estimation and result in considerable error, thus affecting the usefulness of the information.

Companies reporting under International Accounting Standards are permitted to report expenses based on either function or nature. So, this is not a new concept.

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**12. Principle: Disclosures must provide all the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and risk exposures.**

**Current Practice:** Disclosures vary widely in quality and quantity. Older standards frequently provide for scant required disclosures. Some disclosures, for example, those for defined-benefit pension plans (and for stock option expensing prior to the enactment of new standards in this area) have been crafted to make up for inadequate financial reporting in those areas.

**Reasons for Importance:** If investors are to understand the numbers reported in the financial statements, they must have sufficient supplementary disclosures to evaluate the numbers. Such disclosures can include, for example:

- financial reporting methods used,
- models used for estimation and measurement,
- assumptions used,
- sensitivity analyses of point estimates,
- information about risk exposures,
- information explaining why changes in important items have occurred, and

and a host of other important items. In short, the statements are not interpretable without them. Disclosures should be regarded as being as important to investors' assessments as the recognition and measurement in the statements.

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## Chapter 2. A Conceptual Framework for the Comprehensive Business Reporting Model

*People in every walk of life are affected by business reporting. It is the cornerstone on which our process of efficient and effective capital allocation is built. To properly judge the opportunities and risk of investments, they need access to complete information provided by the best sources, including data about the economy, industries, companies, and securities. Unfortunately the current accounting model is out of date and cannot provide all that investors need.*

Stephen G. Butler<sup>5</sup>

*We need accounting standards and a framework for financial reporting based on economic reality which, to my mind, is driven by the ability of businesses to generate sustainable cash flows.*

Ken Lever<sup>6</sup>

A conceptual framework for business reporting must provide a sound foundation for every accounting standard, proposal, and interpretation. We believe, however, that a properly conceived and executed framework must serve also as a benchmark by which the quality of a proposed standard may be judged. The framework must guide standard setters in their deliberations on the development of new reporting pronouncements, but it must also provide a template for assessing whether the standard-setting work is finished or remains deficient in one or more material aspects.

Many observers believe that the current conceptual frameworks in use by major financial reporting standard setters is in need of updating and refinement. In recognition of the deficiencies, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have recently begun a multi-year joint project to revise, update, and strive for convergence of their respective frameworks. The ultimate objective is to develop a single, high-quality set of concepts and principles.

In a recent joint publication of the FASB and the IASB, Halsey Bullen and Kimberley Crook had this to say about the importance of the project:

*Although the current concepts have been helpful, the IASB and FASB will not be able to realize fully their goal of issuing a common set of principles-based standards if those standards are based on the current FASB Concepts Statements and IASB Framework. That is because those documents are in need of refinement, updating, completion, and convergence.<sup>7</sup>*

We agree with these goals.

Similarly, in addressing the question “Why revisit the framework?” in a recent issue of *The FASB Report*, L. Todd Johnson, senior technical adviser and project manager for the Conceptual Framework revisions, states:

*Although the Board continues to utilize the framework in making decisions, most of the framework was developed 20 or more years ago. Because the framework has not kept up with changing times and changing business practices, it needs updating and refining. Moreover, certain aspects of the framework are inconsistent with other aspects of it, and those inconsistencies need to be eliminated. Furthermore, some parts of the framework that originally were planned were not ultimately completed, even though conceptual guidance in those areas*

<sup>5</sup>International Chairman of KPMG, United States of America, XXVIth Annual Conference of the International Organization of Securities Commissions, 28 June 2001.

<sup>6</sup>Finance Director, Tomkins, plc, *Accountancy* (U.K.), July 2004.

<sup>7</sup>Bullen, Halsey G., and Kimberley Crook, “A New Conceptual Framework Project,” *Revisiting the Concepts*, IASB/FASB, 5 May 2005, p. 2.

*continues to be needed. For those reasons, the framework is gradually becoming less helpful in providing guidance to the Board for making standard setting decisions. The need to revisit the framework has become more pronounced with the Board's decision to move toward producing accounting standards that are "principle-based." Such standards, by their very nature, must be soundly grounded in a coherent and cohesive set of concepts that is up to date, internally consistent and comprehensive.<sup>8</sup>*

We strongly support this project and encourage the standard setters to implement needed changes.

We do not, however, intend here to develop a complete conceptual framework. We believe that most of the existing scheme is sound. Rather, our intent is to outline those additional guiding concepts that are essential to ground our proposed Model. Necessarily, some of the concepts we propose conflict with some of the most basic concepts in the current conceptual framework. That is an inevitable concomitant of fundamental change. We will also reinforce, however, some of the principles in the current framework that are critical to the Model.

We must make clear that our proposed additions and other amendments to the framework are not considered lightly but are based upon the changes to the current financial statements that investors routinely must make in order to *try* to generate the data they need to analyze and value securities. Perhaps the most compelling argument for requiring that the reporting changes be made is that if investors must transform financial statements, and the information they contain, into a different form so that they can use the information in their decision making, then the statements and information should be presented in that form in the first place.

A second reason for requiring fundamental changes is that the current reporting model does not provide sufficient information to enable investors to make the required changes. The extreme degree and inconsistent pattern of aggregation and netting of items in the statements—along with the obscured, even opaque, articulation of the financial statements—make such analysis ineffective or impossible. As a result, investors must resort to estimates and best guesses to arrive at information essential for financial decision making. The decisions made can be no better than the quality of the information that supports them. If the poor quality of the statements is an impediment to sound financial decision making, then the quality should be improved.

We believe that our proposed changes to the conceptual framework when fully implemented will resolve some of the most pervasive problems in financial analysis. Other issues, however, remain. For example, investors' ability to understand financial information is a direct function of *how* the information is communicated and not of the information itself. Communicating in a way that is understandable to the investor is a fundamental responsibility of managers who use the investor's capital. Information must be presented clearly, described in a way that is intended to communicate rather than obfuscate, and disclosed in sufficient detail to facilitate understanding by investors.

An essential characteristic of any conceptual framework on which accounting standards are based must be that the resulting financial statements present a "true and fair" view of a company's financial position and any changes to that position. As a consequence, when standards are based on such a conceptual framework and are applied fully and impartially, there is no need for the so-called true and fair view override. In other words, if application of the conceptual framework does not lead to a true and fair view, then the framework itself must necessarily be deficient and should be revised.

A frequently heard argument against standard setters' proposals to require additional disclosures is that investors already suffer from information overload and cannot assimilate any more. We counter that more-accurate and useful information never results in overload. First, whether it is used by investors in every case does not bear on the fact that such

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<sup>8</sup>Johnson, L. Todd, "Understanding the Conceptual Framework," *The FASB Report*, No. 263-D, 28 December 2004, p. 6.

information should represent true and fair value. Second, what burdens investors is extraneous information—disclosure that neither informs nor enlightens, the typical boilerplate prose that remains in companies’ financial reports year after year unchanged or amended in any way. It would appear to many investors that much of the currently available information is designed solely to meet minimum legal requirements for disclosure while providing little of substance to reach the sunlight. Useful disclosure communicates information clearly and succinctly, in formats designed to convey the substance of the company’s current sources of value and how those sources of value have changed and why. Legal obfuscation and boilerplate do not.

## A. Objective of Financial Reporting and Disclosure

Common shareowners are the residual risk bearers in a company. Hence, we believe that the primary *objective* of financial reporting and disclosure must be to provide all of the information that owners of common equity require to evaluate their investments. Common shareowners use this information to make forecasts of future cash flows, evaluate the sustainability of the company’s business model, and assess its cash-generating ability. This information, in turn, is used to estimate the investments’ value and future changes in such value.

Mr. Johnson states the following regarding the objectives of financial reporting:

*...(T)he objectives focus on information about an entity’s economic resources, the claims to those resources, and changes in them (including measures of the entity’s performance). That information is useful to investors and creditors in assessing the entity’s cash flow prospects.*

The objectives, therefore, focus on matters of wealth. *Investors and creditors seek to maximize their wealth (within the parameter of the risks that they are willing to bear). Likewise, business entities also seek to maximize their wealth. It follows, then, that information about the wealth of those entities and the changes in it is relevant to investors and creditors that are seeking to maximize their wealth by investing in or lending to those entities.*<sup>9</sup> [Emphasis added]

We agree and believe that if the information needs of the residual risk bearers are fully met, then most of the needs of those with superior claims will be met as well.

To be useful in making these assessments, reported information must be timely, accurate, understandable, and comprehensive. The financial statements must recognize, as they occur, all events or transactions that affect the value of the company’s net assets and, hence, common shareowners’ wealth. Furthermore, the associated disclosures must provide sufficient information so that investors can understand how the numbers reported in the financial statements were generated, including full descriptions of any estimation models and assumptions that were used to produce the numbers. The disclosures also must fully explain all risk exposures and possible future occurrences whose effects could be expected to affect investors’ wealth.

## B. Concepts

Consistent with the financial reporting objective, the Comprehensive Business Reporting Model we propose is based upon the following 12 concepts.

### 1. The Entity Must Be Viewed from the Perspective of an Investor in the Common Equity Issued by the Company

For a common shareowner, the residual risk bearer in a company, all events and transactions that can affect assets, liabilities, and equities directly and that affect the wealth of the shareowner are material and should be reported and explained. For example, off-balance-sheet financing vehicles can affect the company’s revenues, expenses, cash flows, and risk exposures and can require the transfer of assets to others or create liabilities, thus directly affecting shareowner wealth. Consequently, the effects of such vehicles on the company’s

<sup>9</sup>Ibid, pp. 1–2.

assets and liabilities should be reported on a comprehensive basis in the balance sheet,<sup>10,11</sup> with changes in those items reported in the income and cash flow statements. If shareowners' information needs are met, the needs of other external financial statement users will most likely be met as well. For example, it is our view that providers of debt capital to the company hold an interest in financial reporting nearly identical to that of shareowners and also will be well served by comprehensive reporting.<sup>12</sup>

The IASB would seem to concur with our view in this section from the IASB framework, paragraph F-9<sup>13</sup>:

*...There are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.*

From time to time, the argument is raised that financial reporting that promotes shareowner interests may damage the public interest by failing to place the interests of other so-called stakeholders above those of the investor. For example, in the recent debate about expensing stock options in the United States, representatives of some companies that use options extensively for compensation argued that if expensing were to be required, thereby fully recognizing the compensation component of the company's production costs, the resulting reduction in earnings would cause such companies to have to reduce or otherwise ration the use of options. They argue that this would reduce the amounts of compensation companies could pay employees and limit their ability to attract the most talented employees. They argue further that this would stifle innovation and reduce the competitiveness of U.S. companies. Put slightly differently, these representatives are saying we must choose between complete, truthful financial statements and capitalism. This statement is concerning, both as to its inaccuracy and its interjection of political rhetoric into a traditionally independent standard-setting process.

Financial reporting exists to serve the needs of investors who otherwise cannot command the information they require. In global capital markets, ownership is generally dispersed. Reporting standards, which prescribe financial reporting, are independently created and promulgated in the public arena. Shareowners in publicly traded companies share a common interest in having information to estimate the fair value of their investments. In the context of these global markets and for the purposes of financial reporting, we believe that shareowner interests are congruent with the public interest because efficient allocation of capital is critical for economic growth.

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<sup>10</sup>We believe that our view of the entity is entirely consistent with the objective stated in the FASB's SFAC No. 1, p. 5, that financial reporting should provide information:

*...[A]bout the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources...[and] that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions...*

<sup>11</sup>We recognize, however, that some current accounting standards continue to permit some transactions, for example, some financing vehicles, operating leases, pension liabilities, and executory contracts, to not be fully reflected in the balance sheet or, worse, to escape balance sheet recognition altogether. Such standards tend to rely on "bright line" rules, distinctions that we believe to be arbitrary and that fail to serve the best interests of investors.

<sup>12</sup>We believe that fixed-income analysis differs from equity analysis only in emphasis. For high-yield investments, the difference from equity analysis is especially small.

<sup>13</sup>*Framework for the Preparation and Presentation of Financial Statements*, International Accounting Standards Committee, 1989, and adopted by the International Accounting Standards Board in 2001. Paragraph F-9.

## 2. Fair Value Information Is the Only Information Relevant for Financial Decision Making

Currently, the extant conceptual frameworks contain a list of measurement attributes but lack a fully developed measurement concept. Our goal is for fair value to be the measurement attribute for all assets and liabilities.

In 1993, CFA Institute observed:

*It is axiomatic that it is better to know what something is worth now than what it was worth at some moment in the past...Historic cost itself is in reality historic market value, the amount of a past transaction engaged in by the firm...Historic cost data are never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms (or even within a single firm). There is no financial analyst who would not want to know the market value of individual assets and liabilities.<sup>14</sup>*

Fair value measures reflect the most current and complete estimations of the value of the asset or obligation, including the amounts, timing, and riskiness of the future cash flows attributable to the asset or obligation. Such expectations lie at the heart of all asset exchanges. In the last decade, an increasing number of global financial reporting standards have been based upon fair values, a trend we would wish to see accelerate.

If asset exchanges and, indeed, all financial decisions are based upon fair values, then market efficiency requires that the information upon which such decisions are made should be reported at fair value. The implication is that all items in the balance sheet must be reported at *current* fair value. Furthermore, changes in these values should be reported as they occur in the income statement.

With respect to the measurement of fair value, we believe that managers should look first to the most objective sources of fair value, for example, observable prices for the same or similar assets or liabilities in liquid markets. In the absence of such market-determined measurements, managers must report the best estimate of fair value as determined by widely accepted and applied valuation methods and by using market-based inputs.<sup>15</sup>

Currently, financial statements include some items reported at historical cost while others are measured at fair value, the so-called mixed-attribute system. Consequently, investors who rely on fair values for decision making must expend considerable effort trying to restate to fair value all decision-relevant financial statement items that are measured at historical cost. Their success depends on the sufficiency of disclosure and on the relative reliability of the measurements in the disclosures. Most, if not all, of this effort would be eliminated if the financial reporting standards were to require that companies record assets and liabilities at fair value at inception with periodic revaluation. Indeed, the managers of companies have the best knowledge of the values of the assets and liabilities and, presumably, base their own investment decisions on behalf of the company on such values.

Opponents of fair value reporting argue that measuring and recognizing assets and liabilities at fair value in the financial statements introduces volatility into the financial statements. We argue to the contrary: If fair value measurement results in greater volatility, then the measurement has merely unmasked the true economic reality that was already there.

One of the most important evaluations investors must make is to ascertain the degree of risk to which an investment is exposed: the greater the volatility, the greater the risk. The risk is then weighed against the investment's expected returns. Reporting methods that mask true volatility do a great disservice to investors, impair their ability to make well-founded investment decisions, and can result in inefficient allocations of capital.

<sup>14</sup> *Financial Reporting in the 1990s and Beyond*, Association for Investment Management and Research, 1993, p. 39.

<sup>15</sup> The FASB expects to release a final fair value measurement standard soon. This standard will define fair value, provide guidance on its application in the form of a hierarchy that is intended to foster consistency in its application, and improve fair value disclosures.

If managers choose to hedge economic risks, then comprehensive fair value reporting will allow better hedging decisions and reflect the extent to which these hedging activities have been successful. To achieve this, the reporting should provide full fair value disclosure of both (1) the economic risks hedged and (2) the results of the hedging activities. That is, the fair values for the hedged items and their related hedges must not be netted or deferred, concealing both the underlying risks and management's activities to alter or manage those risks.

We are concerned that standard setters have not implemented a requirement that companies record financial instruments, both assets and liabilities, at fair value. We recommend that standard setters make this a priority and move to adopt and implement the rule.

We understand that moving to fair value measurement for all assets and liabilities may not be feasible in the short term. As a first step, we recommend that standard setters require complete disclosure of fair value information for other financial assets and liabilities, including those that are off balance sheet. These disclosures should explain the degree of uncertainty in a particular measurement. For example, investors need to know whether observed market prices or pricing models and assumptions were used to estimate the fair value and the extent to which management used judgement rather than market inputs to determine the measurement. For such measurements, sensitivity analysis is critical and should expose any nonlinear effects from changes in market or other economic conditions on the fair value. Investors understand that uncertainty is a characteristic of the measurement of every recognized asset and liability. What is important is that managers disclose the degree of measurement uncertainty and its sources.

### **3. Recognition and Disclosure Must Be Determined by the Relevance of the Information to Investment Decision Making and Not Based Upon Measurement Reliability Alone**

Relevance and reliability may seem simple concepts at first. When used in the context of financial reporting, however, they are actually quite complex. Information is relevant when it “influences the economic decisions of users by helping them evaluate past, present or future events or [when they are] confirming or correcting their past evaluations.”<sup>16</sup> Consequently, investors, who must rely on financial statement information, need to receive all relevant information. Moreover, the information required may differ depending upon the requirements and focus of investors' decisions and the analysis necessary to support those decisions.

Timeliness is also an important attribute of relevance. Indeed, information that is not timely may no longer be relevant. While we recognize that the benefits of providing some items of minor relevance may not be justified when compared with the costs associated with measuring and reporting the items, we find altogether too often that these constraints serve as excuses for managers to withhold relevant information from shareowners.

Reliability has been much misunderstood and misused in the financial markets. Indeed, reliability has in some quarters been taken to mean certainty of occurrence and measurement. Such an interpretation was never intended by standard setters. Rather, reliable information is that which faithfully represents the events that it “purports to represent or could reasonably be expected to represent.”<sup>17</sup> We think this aspect of reliability is essential in the debate over the trade-off between relevance and reliability. In fact, we believe this is an essential attribute of relevant information.

Even more problematic from our perspective is the role that a misunderstanding of the concept of reliability has come to play in convincing standard setters to permit relevant information to be moved first off balance sheet and then out of the financial disclosures altogether. We cite as examples the U.S. debate on the treatment of pension obligations two decades ago and fair value reporting of derivatives in the EU recently.

<sup>16</sup> *Framework for the Preparation and Presentation of Financial Statements*, International Accounting Standards Committee, p. 28.

<sup>17</sup> *Ibid.*, p. 29.

#### 4. Complete Recognition of All Economic Transactions and Events

We have already discussed the importance of comprehensive reporting of events in the financial statements. This issue is so fundamental to reporting, however, that we believe it must serve as a separate concept and benchmark criterion. Completeness requires the financial statement recognition and measurement of economic events that can affect investors' wealth, including all changes in fair value, as they occur. This means that no accounting standard should permit assets or liabilities, and changes in them that can affect shareowners' wealth, to escape recognition in the financial statements. For example, where assets are jointly owned or obligations are shared with one or more entities, then the amounts to be recognized should be based upon the company's and, therefore, the shareowners' potential risk exposures in those activities and their expected rewards for bearing the risks. Such recognition and measurement are entirely consistent with fair value reporting.

This means, of course, that all activities that are currently off balance sheet as a result of accounting standards or other conventions must be recognized, including executory contracts. Executory contracts, arrangements for which performance by the various parties is still in progress, represent commitments entered into by a coormance by the various parties is still in progress, represent commitments entered into by mpany that will affect shareowners' wealth and should be recognized as any other obligation would be.

#### 5. Investors' Wealth Assessments Must Determine the Materiality Threshold

Materiality must be evaluated from the perspective of whether the information under consideration would make a difference to an existing common shareowner's assessment and valuation of the investment. The use of arbitrary quantitative thresholds, such as 5 percent of some income statement number, to assess materiality does not serve investor interests. We believe that if there is doubt about materiality, the item should receive separate recognition and measurement, accompanied by sufficient disaggregated disclosure.

#### 6. Financial Reporting Must Be Neutral

It has long been established that an accounting treatment must be based solely on what method best captures the economic substance of an item, a transaction, or event and not on the form of the transaction or the outcome produced by the reporting. Therefore, decisions about the appropriate treatment to be applied must *not* be influenced by an entity's size, its geographic location, manager's intent, or any other attribute unrelated to the economic substance of the transaction. As we stated in *The FASB Report*:

*The purpose of financial reporting is to tell a company's economic story, its financial position and the results of its operations, as completely, clearly, and faithfully as possible. In other words, its job is to tell the story as it is. The role of fiction is to tell the story as it isn't now, and perhaps never was or ever can be, but rather as the author would like the story to be told. A writer of fiction may well have some other objective than merely spinning a good yarn, including possibly a desire to influence some outcome.*

*To the extent that financial information is manipulated to achieve a particular outcome rather than to faithfully report economic events and activity, the resulting information is biased. Neutral information is free from bias. For information to have value to investors and other users, it is critical that it be neutral.*

*Investors depend on financial information for their investment decision-making. For example, investors routinely use financial disclosures in evaluating a company's growth prospects, its riskiness, and the long-term success of the company's business model. These analyses also provide the inputs investors need to price individual securities and to make portfolio decisions. Taken altogether, the quality of investors' pricing and capital allocation decisions affects the relative efficiency and effectiveness of financial markets.<sup>18</sup>*

<sup>18</sup>McEnally, CFA, Rebecca, and Patricia Walters, CFA, Constituents' Commentary, "The Critical Nature of Neutral Financial Reporting," *The FASB Report*, Association for Investment Management and Research, 29 August 2003.

Simply put, when financial disclosures do not tell the economic story as it really is, the prices of securities, and even the amounts of capital allocated to companies, are less likely to reflect the company's actual economic position.

The standards currently permit wide flexibility in financial reporting choices and have led to earnings manipulation and abuse, which have further diminished net income's usefulness in making economic decisions. This flexibility allows managers to report similar transactions in very different ways, producing widely different financial statement effects. As we have observed, the method chosen is frequently driven not by what best reflects the economic substance but by the outcome preferred by managers to position the company in the best light, a clear violation of neutrality. More importantly, what managers deem to be the best light does not always mean the most honest and objective light. It is essential that economic transactions and events with similar economic substance be accounted for in the same way. We do not see the logic in permitting issuers choices either in recognition, measurement, or display based on attributes other than economic substance.

In a closely related issue, company managers have shown a propensity for arguing that items be included or excluded from reported earnings depending upon whether the result suits their "non-neutral" objectives. Such discretion has led to some of the biggest accounting frauds in history. The recent debates regarding proposals to expense employee stock options and to report derivative instruments at fair value are perfect cases in point.<sup>19</sup> These attempts to distort financial reporting to achieve an outcome unrelated to the economic substance of transactions and events are a great disservice to the millions of investors worldwide who provide the capital the companies depend upon.

Some investors believe that managers have an inherent bias toward overstating earnings and equity and that the financial reporting concept of conservatism does much to rein in management optimism. These investors prefer that management use caution when selecting from the unbiased range of outcomes for a particular measurement. With respect to insurance reserves, for example, they prefer that managers be conservative when selecting the point estimate to be reported from the acceptable range. Conservatism would push managers toward the high end rather than the low end of the likely range of losses.

Conversely, strict fair value reporting demands that managers determine the unbiased expected value by forecasting the possible outcomes and by applying probabilities to each of the outcomes. The concerns of some investors about conservatism on the one hand, and the concerns of others about the degree of bias, positive or negative, in a measure on the other, can both be met if the standards require that the range be disclosed when the range about a point estimate is large relative to the estimate: the wider the range, the more important the disclosure. A circumstance where disclosure of the range is critical is when managers decide that the point estimate should be zero, for example, when lawsuits have been filed against a company. Sensitivity analysis is particularly useful in such circumstances because the point estimate does not provide the necessary context in which to understand the reported amount.

## **7. All Changes in Net Assets Must Be Recorded in a Single Financial Statement, the Statement of Changes in Net Assets Available to Common Shareowners**

As we have stated, all events and transactions that can affect assets, liabilities, and equities, and thus the wealth of an investor in a company, must be recognized in the financial statements. Changes in those items must be recorded in a single, highly transparent, and comprehensive financial statement. That is, there should be no category of items, such as other comprehensive income, for example, that escapes recognition in the primary changes in the net assets statement.

Under the current model, accrual net income or earnings is an accounting construct, not an economic measure. Net income is the result of the recognition of *some* revenues and gains on accounting transactions less *some* expenses and losses. As long as a single summary

<sup>19</sup> These projects are now completed.

statistic—the net income number—is reported and reporting standards allow managers flexibility in reporting choices, we believe managers will continue to manipulate the number to suit their needs rather than those of shareowners. Therefore, we are proposing a financial reporting model that does not focus on a single earnings number.<sup>20</sup> This will require investors to analyze the individual reported items and the financial statements as a whole to determine which information is relevant to their financial decision making. We would observe that investors routinely make these assessments in evaluating their investment opportunities.

Currently, although financial statements must of necessity articulate, that articulation is opaque to investors. The reason is that the statements do not follow a consistent structure or the same pattern of aggregation. Only when all of the changes to individual items are made clear, and the measurement characteristics of items are fully disclosed, will investors be able to understand a company's process of wealth generation and the prospects for their investments.

We develop the Statement of Changes in Net Assets Available to Common Shareowners in Chapter 3.

## **8. The Statement of Changes in Net Assets Available to Common Shareowners Should Include Timely Recognition of All Changes in Fair Values of Assets and Liabilities**

The Statement should be comprehensive, including the effects of all events and transactions that affect existing common shareowners' wealth, other than transactions with these shareowners. As we have made clear, we believe that all assets and liabilities should be recorded at fair value. Similarly, we believe that all changes in these fair values should be recorded in the Statement as they occur. The fair value changes should include remeasurements resulting from exogenous events, such as changes in interest rates.

One implication of this principle is that so-called recycling of gains and losses will be eliminated. That is, there will be no deferral of recognition of fair value changes by recording such changes in equity, contingent upon future events. An example of such delayed recognition is the current treatment of available-for-sale securities. Although these securities are marked to fair value in the balance sheet, the resulting period-to-period changes in fair values do not flow to the income statement for immediate recognition but rather bypass the income statement and are deferred in equity until they are sold.

## **9. The Cash Flow Statement Provides Information Essential to the Analysis of a Company and Should Be Prepared Using the Direct Method Only**

The IASB describes some of the benefits of cash flow information:

*A cash flow statement, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.<sup>21</sup>*

<sup>20</sup>Hirst, D. Eric and Patrick E. Hopkins in *Earnings: Measurement, Disclosure, and the Impact of Valuation*, Research Foundation of AIMR, 2000, pp. 13–14, state:

*...[A]nalysis of historical earnings is usually an important precursor to forecasting relevant inputs, [but] what are the relevant historical earnings? Net income? Operating income? Income before extraordinary items? Comprehensive income? Of course, the definitive answer is: It depends.*

<sup>21</sup>International Accounting Standard (IAS) No. 7, effective 1 January 1994, paragraph 4.

In order for users of the statements to be able to make these assessments, the information provided in the cash flow statement must be fully transparent. That is, *the individual categories of cash inflows and outflows must be disclosed clearly and unambiguously*. Current standards generally permit companies to choose between the indirect and the direct methods. The indirect method chosen by the vast majority of companies fails to provide adequate information for analysis. Instead of providing the essential information on cash inflows and outflows, the indirect method begins with net income and “patches” the income number, purging noncash elements and adjusting for changes in cash flows not reflected in current-period income. Put simply, the only pure cash flow number in the operating cash flow section of an indirect method cash flow statement is the total, Cash Flows from Operations.

CFA Institute, reflecting on users’ experience with cash flow statements prepared under current accounting standards, observed in 1993:

*...Cash flow statements that have appeared in published financial reports have been much less useful in analysis than we might have expected. First, almost no public company presents its cash flows from operations using the direct format; virtually all use the indirect format. We have learned...that it is extremely difficult or impossible in most cases for financial statement users to calculate reasonable estimates of gross operating cash flows (direct method) using only the data provided in financial reports in the indirect format.<sup>22</sup>*

If cash flow information is essential to investors when they are forecasting future cash flows, and the indirect method does not provide the needed information or enable investors to generate it from the data, then companies must be required to use the direct method.

## **10. Changes Affecting Each of the Financial Statements Must Be Reported and Explained on a Disaggregated Basis**

For investors to be able to understand the changes that have occurred in financial statements and, consequently, to their wealth, it is essential that they be able to analyze the individual forces at work that affect the company’s performance. Accounting standards currently permit assets and related liabilities, revenues, and expenses, as well as investing and financing cash inflows and outflows, to be reported on a highly aggregated or netted basis, causing much important information to be obscured or lost altogether. The information loss can result in misleading analyses, distorted conclusions, and suboptimal investment decisions. Such aggregation and netting should not be permitted.

Similarly, we do not believe that netting should be permitted for individual line items. For example, changes in the property, plant, and equipment account can arise as a result of (1) purchases and exchanges, (2) sales and abandonment, (3) self-construction, (4) mergers and divestitures, (5) leases, (6) foreign currency changes, (7) depreciation, and (8) impairment write-downs. Clearly, information as to the precise source of the change is essential if investors and other users are to evaluate managers’ investments in productive capital, the effectiveness of managers’ decisions to invest scarce capital, and the value of the company’s capital.

Some of the information for property, plant, and equipment was formerly required to be reported by publicly listed companies in the United States in 10-K filings with the U.S. SEC. When these schedules were no longer required (1994), investors could no longer determine why highly material changes, frequently amounting to billions of U.S. dollars, were occurring in the accounts. It is important to note that the IASB’s International Accounting Standard (IAS) No. 16 requires a full reconciliation of the change in gross fixed assets and accumulated depreciation.<sup>23</sup>

<sup>22</sup> *Financial Reporting in the 1990s and Beyond*, Association for Investment Management and Research, 1993, p. 65.

<sup>23</sup> For a good example, see footnote 17 of the 2004 financial statements of Roche, a Swiss multinational that reports using IAS standards. This footnote shows the effects on the net book value of fixed assets of acquisitions, divestitures, currency translation, depreciation, and impairment.

## **11. Individual Line Items Should Be Reported Based Upon the Nature of the Items Rather Than by the Function for Which They Are Used**

By “nature,” we mean that items should be reported by the type of resource consumed, such as labor or raw materials, rather than by the function or purpose for which it is used, for example, cost of goods sold or selling, general, and administrative expense. Categorization according to nature can greatly enhance comparability across companies and consistency within the statements of a single company. Currently, users of the statements cannot determine from the statements or related disclosures where individual items, for example, pension expense and depreciation, are recorded in the income statement.

The statistical distribution properties of the various resources consumed in operations behave very differently over time. Consequently, aggregation by function, the current practice, merges items with different properties, reducing the information content of the items and significantly reducing their value as decision-making factors. We believe that functional disclosure is best reserved for segment reporting where the categories are most likely to be more nearly homogeneous and, therefore, more meaningful for assessing the profitability of individual units.

## **12. Disclosures Must Provide All of the Additional Information Investors Require to Understand the Items Recognized in the Financial Statements, Their Measurement Properties, and Their Risk Exposures**

Although disclosures are not a substitute for recognition and measurement in the financial statements, they are essential if investors are to understand the statements. The role of disclosure is to provide a comprehensive explanation of events or transactions that have been recognized, including the models, estimates, assumptions, and principles that were applied to measure the effects, and the sensitivity of the reported information to changes in those principles and assumptions. To the extent that financial statement line items present aggregated information, disclosures must enable investors to disaggregate.

The same qualitative characteristics of financial reporting (including understandability, completeness, relevance, reliability, and comparability) apply equally to the written disclosures that supplement the financial statements. The information and measurements contained in such disclosures should not be any less reliable than those recognized in the financial statements and should be subjected to the same level of audit scrutiny that the numerical items in the statements receive. To the greatest extent possible, these written disclosures should pertain to the individual characteristics and circumstances of the company involved and avoid routine, legal boilerplate. Finally, until financial statements are of sufficient quality that they no longer require investors to make substantial fair value and other adjustments, disclosures must provide the essential information investors need to make these adjustments. As we have made clear, however, fair value recognition will not remove the need for disclosures about the fair value measurement process.

When standard setters consider new or amended recognition and measurement criteria, disclosures must be developed concurrently, not after recognition and measurement decisions are made. Disclosures must be treated as essential and indispensable commentary to the financial statements, rather than as a mere postscript.

### **C. Definitions**

The proposed conceptual framework has important implications for the definitions of assets, liabilities, and equity. Therefore, we propose the following alternatives to the current definitions.

## 1. Assets

An enterprise must recognize an economic resource as an asset in the financial statements when all of the following conditions are met:

- a. The resource is a present right or other access to a future benefit that will flow to the company and will contribute directly or indirectly to future net cash inflows;
- b. The right to the future benefit is controlled by the company;
- c. There is a nonzero probability that the benefit will occur;
- d. The right to the future benefit is separable from the company; that is, it can be transferred to an external party;
- e. The right to the future benefit is the result of past events; and
- f. The fair value of the right to future benefits can be measured.

## 2. Liabilities

An economic obligation must be recognized as a liability in the financial statements when all of the following conditions are met:

- a. The obligation exists currently;
- b. There is a nonzero probability that the obligation will be settled by an outflow of assets, issuance of another liability, or other settlement that will result in a change in the share of net assets available to current shareowners;
- c. There are sufficient penalties to the enterprise from nonperformance that the enterprise has no realistic alternative to settlement;
- d. It does not meet the definition of equity; and
- e. The economic attributes and fair value of the obligation can be measured.

## 3. Equity Interests

We will distinguish between two classes of equity interests: residual common shareowners' equity and other equity interests. Common shareowners' equity is the interest of *current owners* of common equity in the residual net assets of the enterprise. Other equity interests includes, all remaining classes of shareowners whose interests precede and are preferential to those of the residual common shareowners. Hence, other equity interests would include shares representing ownership in a specific division or subsidiary of the company, that is, minority interest. This category could also include instruments that in economic substance grant the current holder a perpetual interest in the assets of the company similar to that of the minority interests, such as possibly some forms of perpetual preferred stock. The precise terms of the instruments, however, would have to be carefully scrutinized to determine the economic substance of the interests. We also believe that a rebuttable presumption should exist that such instruments represent obligations rather than equity interests.

In general, financial instruments masquerading as equity instruments whose terms provide the holders with prior or preferential access (relative to the residual interest of common shareowners) to company cash flows or other assets should be classified as liabilities. Similarly, instruments, such as stock options, that require the future transfer of a portion of the net assets of *current* common shareowners to the holders of the instruments must also be classified as liabilities. Depending upon the terms of the instruments, they should be classified as Short-Term Liabilities, Long-Term Obligations—Definite Maturities, or Long-Term Obligations—Indefinite Maturities.

These disclosures are consistent with our general view that financial statements should be presented from the point of view of the ultimate risk bearer in the company, the current residual common shareowner. Claims against the current residual net assets that are prior or superior to those of the residual common shareowner should be presented as just that, superior claims.

## D. Specific Implications of the Conceptual Framework

These proposed amendments and changes to the conceptual framework and the proposed definitions of assets, liabilities, and equity have important implications for current financial reporting standards. We would like to discuss just a few of them here.

Deferral of defined-benefit plan actuarial gains and losses is incompatible with fair value reporting. All changes in the fair values of the liabilities must be included in pension expense in the period in which they occur. The corridor approach is an unfortunate result of the common but improper objective of smoothing the accounting recognition of economic events, and it conflicts with several of the concepts mentioned previously.

From the perspective of current common shareowners, the granting of stock options to employees creates an obligation that transfers wealth from current common shareowners to employees. Therefore, it is irrelevant whether the obligation will be settled with cash, or other assets, or settled with equity; the obligation must be classified as a liability.

Special hedge accounting is an artifact of the mixed-attribute model, is based upon managers' intent, and results in the selective recognition of only some fair value gains and losses. The fact that it exists only to permit managers to offset losses with gains, thereby reducing reported volatility, is arbitrary. Only when all transactions are fully and separately accounted for at fair value and on a disaggregated basis will investors have a clear picture of both the risks to be hedged and the effectiveness of any hedging instruments or strategies used.

The objective of financial reporting is to describe in accounting conventions what is the actual financial condition of a company and not what managers would like it to be. Several of the concepts we propose are diametrically opposed to and would help prevent accounting as determined by intent. The rationale for managers' engaging in particular transactions or business strategies is best included in the disclosures. These disclosures must also include quantitative information that clarifies managers' effectiveness in achieving their objectives.

When viewed from the perspective of current shareowners, a downward change in the company's credit rating necessarily means that wealth is transferred from existing bondholders, who have already committed to an interest rate and thus bear the risk of changes in the interest rates, to shareowners. If bondholders had waited to purchase the obligations, they may well have received a higher interest rate. What is unsettling to many, however, is the fact that the fair value recognition of a negative credit change results in a gain to the company and an increase in shareowners' wealth. Such an occurrence is not a fluke of fair value reporting but rather is the inevitable result of the differential contractual claims of the bondholders and shareowners. We should note, however, that the increase in shareowners' wealth resulting from the credit downgrade may well be accompanied by a decline resulting from lowered expectations regarding the health of the company.

## Chapter 3. The Comprehensive Business Reporting Model—Our Proposals for Revision

*[A]ccounting can aspire to no nobler objective than to reflect the underlying business activity it purports to represent. To achieve this goal, the profession must continue to monitor business reporting and evolve in a way that it continues to provide the most relevant representation of business performance.*

Philip D. Ameen, CPA<sup>24</sup>

*“[Since] accounting is, by fiat, a matter of design, accounting can be whatever we want it to be.”*

Stephen S. Penman<sup>25</sup>

We believe that the current business reporting model requires a number of major changes so that it can fully and clearly communicate the operations of a 21<sup>st</sup> century company to its investors and to better serve their needs for information.

Briefly, we propose a set of revised financial statements, some of which are new. As we have made clear in Chapter 2, we believe that because fair value is the only relevant basis for financial decision making, fair value should be the only measurement attribute used in the financial statements. We have a responsibility, however, to propose statements that can serve investors well with today’s mixed-attribute model and during the period of transition to the fair value model. Consequently, the statements that we propose accomplish this objective as well. One by-product of accommodating the mixed-attribute model during the transition to fair value is that our proposed model lays bare many of the infirmities of the current model.

Investors are interested in a number of major issues, including:

- How companies create wealth;
- How sustainable is the wealth-generation process;
- How the wealth is dispersed to the various superior stakeholders; and
- How wealth accrues to the residual common shareowners, the ultimate risk bearers.

It is apparent from this list that investors cannot focus solely on a single earnings number to make their investment decisions. Rather, investors require information about a variety of different concerns, including:

- Resources the company controls;
- Obligations to transfer resources to others;
- The ability of the company to generate long-term, sustainable net inflows of resources;
- The ability of the company to convert the new resource inflows to cash; and
- The risks to which these resource-generating activities and cash flows are exposed, both in the near term and in the long run.

In order to answer these questions, investors must understand (1) the economic activities underlying the financial statements and the reported numbers and (2) the processes managers have used to produce the financial statements and disclosures. If investors are not able to untangle and decipher these activities and processes, then they will not be able to address the larger questions. Their ability to do so depends directly on the business reporting model, its clarity, its completeness, the transparency of its articulation, and the quality of the measurement

<sup>24</sup>Vice President and Comptroller, General Electric Company, “Six Sigma Accounting in the New Millennium,” The Saxe Lectures in Accounting, Baruch College of the City University of New York, 1 November 1999.

<sup>25</sup>“The Quality of Financial Statements: Perspectives from a Recent Stock Market Bubble.” *Accounting Horizons*, vol. 17, Earnings Quality Supplement, 2003.

of items in the financial statements.<sup>26</sup> As Martin Whitman, CFA, states, “each accounting number is derived from, modified by, and [is a] function of all other accounting numbers.”<sup>27</sup> To understand one, investors must have the means to understand them all.

If investors are to understand better how companies are creating wealth, whether their activities are increasing or decreasing their investors’ wealth, and whether the wealth generation is sustainable, much greater attention must be paid to the balance sheet and cash flow statements, to the quality of measurement of items reported in them, and to the relationships among the items. With respect to the balance sheet, because wealth can be created or lost by holding assets and liabilities, we believe that the fair values of both recorded and currently unrecorded assets and liabilities must be reported.

At present, the balance sheet includes measurements of dubious relevance that are generated using a variety of different measurement bases, including historical cost, amortized cost, observed fair market values, and managers’ estimates of values. The different measurements are mixed together with, in most cases, insufficient information in the disclosures for investors to determine which bases have been used and whether the accounting processes have captured the underlying economics. Equally problematic is that changes in these measurements are not required to be recognized in one statement. Rather, they are dispersed between the income statement and, increasingly, directly into Other Comprehensive Income, a category of equity bypassing the income statement altogether.

The ultimate objective of the wealth-generation process is to generate cash. Thus, it is critically important for investors to understand how companies generate cash and how they manage cash receipts and payments. Investors will achieve this understanding only when the business reporting model communicates the process clearly and completely.

Investors need a reporting model that better communicates the risks and uncertainties implicit in the events and transactions and in the amounts recognized in the financial statements. This information should be reported in such a manner that it can directly support the development of forward-looking estimates of sustainable cash flows. Academic research confirms that “disaggregating earnings into cash flow and the components of accruals enhances earnings’ predictive ability relative to aggregate earnings.”<sup>28</sup> It is not surprising that disaggregating the earnings series would improve predictive ability, a primary purpose of financial reporting, because information lost in the aggregation process is preserved in the separate series. In addition, separate reporting of cash flows and accruals permits investors with different analysis and investment objectives to apply different weights to the series in developing forecasts and valuations. This research supports our call for a new business reporting model, one that disaggregates the jumbled income statement and cash flow numbers and that clearly and completely communicates both cash flow information and accruals.

Recent research by D. Eric Hirst and Patrick E. Hopkins shows that how and where reported information is displayed affects investors’ understanding of the reported information as well as their ability to incorporate all relevant information into their valuation models.

*Because of the difficulty inherent in assessing the relevance and persistence of the... [financial statement] amounts, users of financial accounting information often must sort through voluminous notes and nonfinancial information to effectively forecast the future earnings, cash flows, or intrinsic value of a company. This wide dispersion of value-relevant information increases the direct and indirect cost of valuation activities.*<sup>29</sup>

<sup>26</sup>Of course, it depends as well on the good faith of managers in applying the model fully and completely and striving for clarity and understandability for both the good news and the bad rather than obscuring any negative or undesirable outcomes.

<sup>27</sup>Whitman, Martin J., CFA, “Letter to Shareholders,” Third Avenue Funds, Third Quarter Commentary, 31 July 2004, p. 2.

<sup>28</sup>Barth, Mary, et al., “Accruals and the Prediction of Future Cash Flows,” *Accounting Review*, vol. 76, no. 1, January 2001, p. 28.

<sup>29</sup>Hirst, D. Eric, and Patrick E. Hopkins, “Income Reporting and Valuation Judgments,” *Journal of Accounting Research*, vol. 36, Supplement, pp. 47–48.

Transparency and accessibility of information are as important as its relevance and reliability if investors are to more fully incorporate the data into their analyses and judgments. We believe that a complete cost-benefit analysis would show that it is more costly for many investors to independently engage in search-and-find missions than it is for companies to display information succinctly, clearly, consistently, and in accessible formats. Hence, to achieve this objective, we propose a set of new financial statements with revisions to the remaining old ones. The statements retain the most useful characteristics of the old statements but also:

- Expand the information sets presented;
- Disaggregate cash flow and accrual information;
- Distinguish among the measurement bases for individual items, for example, cash flows, accruals, and fair value measurements;
- Disaggregate functional categories so as to provide disclosure by the nature of the item; and
- Reveal the articulation of the individual line items in the financial statements.

## A. The Comprehensive Business Reporting Model

We propose that standard setters provide investors with a revised set of four financial statements. Each statement is of equal importance. The first three statements provide information at a high level of aggregation. The fourth statement provides a level of disaggregation that is missing today and which is critical to investors' understanding of how the other statements, and the items in them, articulate. This set of financial statements comprises:

1. **Comparative Balance Sheets**—Minimum of two years, with accounts listed in order of decreasing liquidity within each category.
2. **Comparative Cash Flow Statements**—Minimum of three years, prepared using the direct method, with a supplemental schedule of significant noncash financing and investing activities.
3. **(New) Comparative Statements of Changes in Net Assets Available to Common Shareowners**—Minimum of three years, that:
  - a. Identify and distinguish among:
    - i. Current-period accrual transactions;
    - ii. Estimates and allocations; and
    - iii. Changes in the fair values of balance sheet accounts.
  - b. Provide information by nature of the resource consumed rather than the function for which it is consumed; and
  - c. Display transactions with owners that affect net assets, such as dividends and new share issuances.
4. **Reconciliation of Financial Position**—Reconciles the comparative balance sheets by further disaggregating the amounts in the statements mentioned previously and by clearly showing how the statements articulate.

In the remainder of this chapter, we explain and illustrate the details of each of these four statements. We provide sample financial statements and the relevant journal entries for Trans-Global Exports, Ltd., a small specialty manufacturer of tools. These statements include the (1) proposed balance sheet, (2) direct method cash flow statement, (3) statement of changes in net assets, and the (4) reconciliation statement, respectively.

In addition, consistent with our view that fair values must be used for the measurement of assets and liabilities, we believe it is important that we provide a more detailed example of the information than we would expect to see in actual practice in the proposed financial statements. Therefore, we provide an example of an interest rate swap in Figure 6,<sup>30</sup> which is already measured at fair value under U.S. GAAP, illustrating how the initial and subsequent

<sup>30</sup>McConnell, Patricia A, *Derivatives and Hedging: The FASB Solution*, Accounting Issues, Bear Stearns Equity Research, 5 February 1998, pp. 24–29.

transactions would be reflected in the proposed statement of changes in net assets and in the reconciliation. The latter also shows the information that would appear in the balance sheet and cash flow statement. The journal entries are those that would be recorded under Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

## **B. Classification: Operating, Financing, Investing**

Standard setters worldwide, working in a variety of contexts, have sought without success to define those activities that should be classed as operating and to provide a sharp distinction between such activities and other classifications, such as nonoperating, investing, and financing. Indeed, drawing the line between operating and investing activities is fraught with conflicts and ambiguities, particularly in the case of financial institutions and manufacturing companies that provide long-term financing to their customers. Similarly, many observers feel that sharp distinctions cannot always be clearly made between operating and financing activities. Some financing from such sources as suppliers, banks, and other investors is inextricably linked to operations and the level of a company's business activity. Other third-party financing, for example, the issuance of long-term bonds, is of a much more general nature and is at best indirectly linked to operations. Still others believe that a distinct line cannot be drawn between investing and financing activities. One possibility that must be entertained is that although such distinctions were routine convention in the past, they may not, in fact, be distinguishable on an economic basis in today's company with its complex global integration of manufacturing operations and financial structures. That is, operating, investing, and financing activities may be familiar and, therefore, comfortable constructs, but that may not be readily distinguishable in today's economic reality.

Given these difficulties, standard setters have concluded that the expedient solution is to define as financing those activities that most observers could agree were probably financing for most businesses and similarly for investing activities. With these two categories at least minimally defined, operating activities are then defined by default as the residual, what is *not* either financing or investing. We recognize that developing a clear definition of operating activities will not be easy. Indeed, the goal of creating standardized, unambiguous definitions may be impossible. Furthermore, we recognize that what constitutes operating activities may differ by industry and even more subtly for different companies within an industry.

Despite these difficulties, we believe that standard setters should continue their quest to define these issues. These categories are relevant to investors because they have different valuation implications. It is important for investors to understand a company's operating activities and to be able to differentiate between these and other activities that may obscure operating results.

Assuming for the moment that the categories can be unambiguously defined, then all transactions and events related to these activities should be similarly classified, including their tax and foreign exchange consequences. In addition, because it is classification of *activities* that is relevant, only those statements that report activities would be classified: the Cash Flow Statement and the Statement of Changes in Net Assets.

In advocating that standard setters attempt to define these three categories and that companies be required to apply them in classifying their reported activities, we recognize that some flexibility will be necessary for companies to accurately report their operations. This may come at the cost of comparability, which is a very important characteristic of financial reporting for investors. We are also concerned that some companies may manipulate these classifications in order to obscure rather than to communicate economic reality. Nevertheless, we believe that requiring consistency in classification across accounting periods, along with sufficient disclosure (most particularly the proposed reconciliation statement), will permit investors to reclassify items as needed for their analyses. Despite our concerns about the current definitions and reporting for these categories, we will follow the general outline in our statements that report activities.

With respect to income taxes, however, tax expense must be distributed appropriately among the operating, financing, and investing categories because the tax expense is a function of specific activities. Conversely, the resulting cash payment for tax cannot be disaggregated because it is the net effect of all activities in a particular jurisdiction.

### C. Balance Sheet

The balance sheet provides investors with information about a company's wealth:

1. The resources it controls;
2. Any recorded claims against existing resources;
3. Claims that will consume future resources;
4. The relative liquidity of the resources; and
5. The relative time to maturity of the claims against resources.

The importance of the balance sheet to investment decision making has diminished in recent decades. Arguably, this is a result of a variety of factors, including:

- An increased interest in investments in equity securities with their typically widely dispersed ownership;
- A concern for growth as compared with assets that could be quickly converted to cash;
- The reduced relevance of historical cost-based numbers for decision making;
- The tendency, now somewhat slowed, to allow ever greater amounts of resources and associated financing to escape balance sheet recognition altogether, for example, with pension benefit obligations, operating leases, and special purpose and variable interest entities in addition to more general commitments; and
- Ease of manipulation under current conventions.

We believe that it is time to refocus attention on the balance sheet, to correct its deficiencies, and to restore its usefulness as a communicator of essential information about companies. In Chapter 2, we made clear that we believe that:

1. All assets controlled by the company and all liabilities that can consume investors' wealth should be recorded in the balance sheet;
2. All items in the balance sheet should be reported at fair value on a timely basis;
3. Items should be disaggregated;
4. Items should not be netted;
5. Items should be reported by nature rather than function;
6. Similar items should be classified together by category; and
7. All assets and liabilities should be ordered by liquidity, specifically by decreasing liquidity, within their respective categories.

These principles are routinely violated in the current balance sheet process, reducing its transparency and usefulness to investors. An investor should be able to readily determine the company's net wealth at the balance sheet date and, in conjunction with the cash flow statement, be able to evaluate the company's ability to liquidate claims and obligations from the balance sheet. See Figure 1: Trans-Global Exports, Ltd., Balance Sheet.

**Figure 1. Trans-Global Exports, Ltd., Comparative Balance Sheets at 31 December 20X3 and 20X4**

	31 December	
	20X3	20X4
<b>Assets</b>		
Cash	€4,000,000	€ 5,918,411
Marketable securities	0	196,100
Accounts receivable	595,000	845,000
Less: allowance for bad debts	*(20,000)	(70,500)
Net accounts receivable	575,000	774,500
Inventory	850,000	403,750
Leased asset	0	25,756
Investment in affiliate	0	722,250
Building	3,600,000	4,260,000
Less: accumulated depreciation	<u>(100,000)</u>	<u>(275,000)</u>
Net building	€3,500,000	€ 3,985,000
<b>Total assets</b>	<b><u>€8,925,000</u></b>	<b><u>€12,025,767</u></b>
<b>Liabilities &amp; Equity</b>		
Accounts payable	€850,000	€ 375,000
Accrued liabilities	28,000	78,000
Advances from customers	15,000	190,000
Interest payable	0	125,000
Income taxes payable	54,639	75,451
Dividends payable	0	35,000
Current portion of lease liability	0	9,208
Short-term debt	0	500,000
Accrued stock compensation	6,000	13,500
Lease liability	0	24,870
Deferred income tax liability	23,699	56,819
Accrued pension liability	2,400	4,800
Bonds payable	0	<u>2,500,000</u>
<b>Total liabilities</b>	<b><u>€ 979,738</u></b>	<b><u>€ 3,987,648</u></b>
<b>Equity Interests</b>		
<b>Other Equity Interests</b>		
Minority interest	€ 100,000	€ 100,000
Perpetual preferred stock	300,000	300,000
<b>Total other equity interests</b>	<b><u>€ 400,000</u></b>	<b><u>€ 400,000</u></b>
<b>Common Shareowners' Equity</b>		
Common stock	€ 600,000	€ 600,000
Additional paid-in capital	4,000,000	4,000,000
Treasury stock	(100,000)	(100,000)
Retained net assets	<u>3,045,262</u>	<u>3,138,119</u>
<b>Total common shareowners' equity</b>	<b><u>€ 7,545,262</u></b>	<b><u>€ 7,638,119</u></b>
<b>Total equity interests</b>	<b><u>€ 7,945,262</u></b>	<b><u>€ 8,038,119</u></b>
<b>Total liabilities and equity</b>	<b><u>€ 8,925,000</u></b>	<b><u>€12,025,767</u></b>

\*Parentheses indicate negative numbers

## D. Cash Flow Statement

In 1986, when the FASB issued its exposure draft for SFAS No. 95, *Statement of Cash Flows*, to replace the funds flow statement, we urged the board

*...to require a cash flow statement that clearly discloses flows of cash (and cash equivalents) through the entity. The cash flow statement itself should focus only on cash flows and not have its utility and relevance diluted by unwarranted injection of accrual accounting concepts.*<sup>31</sup> [Emphasis added]

At that time, we requested that a single format for the statement be prescribed, and we requested that “as long as net income was considered to be of primary importance, the objective of the statement of cash flows should be to facilitate an understanding and analysis of the income statement.”<sup>32</sup>

By 1990, four short years later when the International Accounting Standards Committee issued a similar exposure draft, we had realized our mistake. In our 27 July 1990 comment letter, we explained that our

*...support [for the indirect method] was based, in part, on the need of financial statement users to understand how reported net income differs from cash from operations and to be able to reconcile the two. We also believed that users who wished to prepare a direct method statement would be able to do so using the data provided in the indirect method reconciliation.”*<sup>33</sup> [Emphasis added]

Our experience then and now tells us that it is impossible for even the most skilled analyst to create a reliable direct method cash flow statement for most companies from existing reported data. The analysis required to approximate a direct method cash flow statement from the available data is difficult and time consuming. The real challenge, however, is not the enormous effort required but rather the fact that the articulation between the balance sheet and the income statement is almost completely obscured. For example, most companies provide insufficient information to permit a skilled analyst to cleanly decompose the entries affecting accounts receivable and to determine cash inflows from sales, the amounts of cash collected from customers. This is the single most important direct cash flow number investors require for analysis and a primary indicator of the company’s cash-generating ability. Gross estimates must be made, greatly reducing the reliability and usefulness of the information generated by the exercise. The same is true to a greater or lesser extent for all of the other numbers in a direct method statement. In addition, it is impossible to relate the adjustments in the indirect method cash flow statement to any single income statement line item.

There is an additional issue that is critical for investors’ use of cash flow information. As our 1990 letter explains, academic research provides evidence that the individual components of cash flow from operating activities have explanatory power that is superior to that of the currently reported total cash flow from operations.<sup>34</sup> That is, information useful for forecasting cash flows is lost in the aggregated single number, cash flow from operations, *the only cash flow number in an indirect method cash flow statement*. The most useful and revealing cash flow components are only available in a direct method cash flow statement.

In the 1993 *Financial Reporting in the 1990s and Beyond*, and again in a 1996 comment letter to the Canadian Accounting Standards Board, we repeated our request for a statement of cash receipts and disbursements. We repeated our belief that such a statement is more useful than the arcane and increasingly obscure indirect method of adjusting net income to remove

<sup>31</sup>McConnell, Patricia, and Gerald I. White, CFA, “Comment Letter of the Financial Accounting Policy Committee of the Financial Analysts Federation to Financial Accounting Standards Board,” 15 October 1986, p. 1.

<sup>32</sup>Ibid, p. 3.

<sup>33</sup>McConnell, Patricia, and Gerald I. White, CFA, “Comment Letter of the Financial Accounting Policy Committee of the Association for Investment Management and Research to the International Accounting Standards Committee,” 27 July 1990, pp. 1–2.

<sup>34</sup>Ibid, p. 2.

noncash items and to patch for cash flow items not recognized in the income statement. We believe that the cost—the effort and resources consumed and guesswork that investors must go through—of the analysis required to develop even an approximation of a direct method cash flow statement clearly exceeds any cost–benefit objections issuers might have for providing it.

Investors use cash flow information as an important reality check on the quality of reported earnings. To the extent that cash flows and earnings diverge, a result of noncash accruals changing at a faster rate than the related cash flow number, investors are put on warning that the reported accrual numbers may be less than reliable indicators of the company’s performance and thus of its wealth-generating ability. The divergence may also signal cash flow difficulties at some time in the future.

Information about significant noncash operating, financing, and investing transactions is also important. Therefore, to provide transparency for transactions structured to avoid disclosure in the Cash Flow Statement, a supplementary schedule or disclosure of these transactions must be required.

See Figure 2, Trans-Global Exports, Ltd., Cash Flow Statement and Significant Noncash Financing and Investing Activities. (In Figure 5, we provide the supporting journal entries for the items reported in the Cash Flow Statement.) Note that these entries include the accruals for the period and fair value adjustments as well, which are not relevant for the cash flow statement.

**Figure 2. Trans-Global Exports, Ltd., Cash Flow Statement and Significant Noncash Financing and Investing Activities for the Year Ending 31 December 20X4**

Cash Flow Statement	20X4	Significant Noncash Financing and Investing Activities	
Collections from customers	€ 2,700,000		
Payments for inventory purchases	*(1,750,000)	<b>Investing Activity</b>	
Payment for labor	(210,000)	Leased building and land	€ 31,700
Payment for rent	(120,000)		
Payment for other services	(100,000)	<b>Financing Activity</b>	
Pension contribution	<u>(1,200)</u>	Lease obligation—building and land	€ (31,700)
<b>Net Operating Cash Flows</b>	<b>€ 518,800</b>		
		<b>Supplemental Disclosures</b>	
Purchase of investment in affiliate	(710,000)	<i>Collections from Customers:</i>	
Capital expenditure—building	(500,000)	Cash sales	€ 250,000
Purchase of marketable securities	(185,000)	Advances	200,000
Dividends received	<u>9,250</u>	Collections on credit sales	<u>2,250,000</u>
		<b>Total</b>	<b>€ 2,700,000</b>
<b>Net Investing Cash Flows</b>	<b>€(1,385,750)</b>		
		<i>Payments for Inventory Purchases</i>	
Interest payment	(125,000)	Cash purchases	€ (300,000)
		Payment for prior-period purchases	(850,000)
Dividend payment	(35,000)	Credit purchases, current period	(600,000)
Issuance of short-term debt	500,000	<b>Total</b>	<b>€(1,750,000)</b>
Issuance of bonds	<u>2,500,000</u>		
<b>Net Financing Cash Flows</b>	<b>€ 2,840,000</b>		
Payment of income taxes	(54,639)		
<b>Net Change in Cash</b>	<b>€ 1,918,411</b>		

\*Parentheses indicate negative numbers

## E. Statement of Changes in Net Assets Available to Common Shareowners

Our proposed Statement of Changes in Net Assets replaces both the Income Statement and the Statement of Comprehensive Income. This statement is designed to:

- Provide the information investors need to understand a company's operations and the events and transactions affecting those operations;
- Require full recognition in a single statement of all events and transactions that can affect investors' wealth;
- Increase the transparency and understandability of the behavior of individual items and the effects these have on a company's operations by requiring that items be reported by nature rather than function;
- Provide information on all investing and financing activities;
- Provide information on the company's transactions with investors, the company's common shareowners; and
- Deemphasize the focus on a single, arbitrary performance indicator, accounting net income.

This statement fully reflects our views on the necessity of providing shareowners with complete and understandable information on all activities, events, and transactions that can affect investors' wealth. As we have made clear in Chapter 2, no transactions affecting investor wealth should be allowed to escape recognition in the primary financial statements. *Rather, all transactions and events that change net assets must be recognized in this single statement, not merely those that are generally considered to be performance indicators.* This requirement means that financial reporting standards would permit both selective disclosure of activities and deferral or allocation of other items to other periods.

We believe that performance assessment is the responsibility of the investor, not managers. The statement of net assets will allow the investor to select those items that are pertinent to the investor's particular perspective, analytic requirements, and objectives. Such a statement would continue to meet the needs of all users of financial statements and at the same time provide the richer dataset that long-term common equity investors need.

We believe that investors will not be able to assess the values of their investments and their prospects unless they are able to understand the forces at work that can increase or decrease that value. This means that individual line items must be reported by the nature of the item, for example, labor cost, and not by the function for which a resource is consumed, for example, cost of goods sold. Aggregation of disparate items results in information loss, and as we have observed, that loss reduces predictive power and analytical value.

This new statement also includes all investing and financing activities because they are integral to a company's operations. Indeed, it is frequently difficult to clearly distinguish among the categories, as we have observed. Investors' understanding of a company's operations will be greatly improved if investing and financing transactions and events are required to be recognized in this statement. At present, investors are left to guess at many such transactions frequently involving highly material amounts.

One direct implication of this comprehensive statement is that it may well have the effect of reducing what we believe to be the market's unwarranted focus on earnings per share (EPS). We believe that this myopic attention on a single number, which is often manipulated, leads to exaggerated market reactions that serve to fuel unproductive and unwarranted market volatility and the "short-termism" of stock market speculators—a disservice to rational investors with a longer-term perspective. Indeed, long-term investors are concerned primarily with fair value and forecasting total return to the investment horizon. The richer dataset may also encourage analysts to develop better forecasting methods that could result in more efficient and effective capital allocation.

Consistent with our view on the components of the statement of changes in net assets, we do not support the continued reporting of a single predetermined EPS number. As we have stated, the earnings used in the numerator of the ratio is an accounting artifact, an aggregate of *some* revenues and gains and *some* expenses and losses, rather than a transparent, economics-based measure of performance. Indeed, most professionally trained analysts today are forced to routinely adjust the earnings number to reflect economic reality. Disclosure of the weighted-average number of shares outstanding would be used to create investor-specific per share metrics as inputs to valuation models. The benefits of these changes would ultimately accrue to the investing public.

Finally, we see no logical reason why transactions with shareowners must be relegated to a separate statement or footnote disclosure. We believe that it is both more effective and cost efficient if such events are recorded in the statement of changes in net assets as a financing activity. This will be particularly helpful in the current environment where some financial instruments blur the distinction between liabilities and equities.

We have designed the proposed format for the Statement of Changes in Net Assets so that it can be implemented for the current mixed-attribute accounting model. It is also intended, however, to be completely appropriate and adaptable to the full fair value model. As the accounting for particular assets and liabilities transitions to fair value measurement, we expect that most estimates and allocations will shift to the Changes in Fair Value column.

See Figure 3, Trans-Global Exports, Ltd., Statement of Changes in Net Assets Available to Common Shareowners, and Figure 5, Journal Entries. We assume that Trans-Global is a small specialty manufacturer of tools and hence has only a single segment. Therefore, items are displayed in the statement by nature and function. Larger firms would show items only by nature in this statement and would provide separate supplementary segment disclosures using the functional categories, just as they do now.

**Figure 3. Trans-Global Exports, Ltd., Statement of Changes in Net Assets Available to Common Shareowners, Year Ending 31 December 20X4**

	Current- Period Accrual Transactions	Estimates	Change in Fair Value of Related Assets & Liabilities	Net Change in Net Assets
<b>Operating</b>				
Sales	€2,775,000			
Bad debt expense		€ (50,500)*		€2,724,500
Cost of goods sold:				
Purchases of inventory	(1,275,000)			
Direct labor	(110,000)			
Allocated overhead		(105,944)		
Ending inventory— beginning inventory		(446,250)		
Total cost of goods sold				(1,937,194)
Other compensation expense	(107,500)			(107,500)
Rent expense	(120,000)			(120,000)
Pension expense	(1,200)	(2,400)		(3,600)
Depreciation expense		(75,000)		(75,000)
Other operating expense	(150,000)			(150,000)
Income tax—operating activities	(99,362)	(33,121)		(132,482)
<b>Net operating activities</b>	<b>€ 911,938</b>	<b>€(713,215)</b>	<b>0</b>	<b>€ 198,724</b>
<b>Investing</b>				
Revaluation of building to fair value			160,000	160,000
Dividend income—marketable securities	9,250			9,250
Marketable securities: revaluation to fair value			11,100	11,100
Equity in earnings of affiliate	12,250			12,250
Income tax—investing activities	(77,040)			(77,040)
<b>Net investing activities</b>	<b>€ (55,540)</b>	<b>0</b>	<b>€171,100</b>	<b>€ 115,560</b>
<b>Financing</b>				
Interest expense	(252,378)			(252,378)
Income tax—financing activities	100,951			100,951
<b>Net financing activities</b>	<b>€ (151,427)</b>	<b>0</b>	<b>0</b>	<b>€ (151,427)</b>
<b>Net change in net assets before     transactions with owners</b>	<b>€ 704,971</b>	<b>€(713,215)</b>	<b>€171,100</b>	<b>€ 62,857</b>
Dividends declared	(70,000)			(70,000)
<b>Net change in net assets</b>	<b>€ 634,971</b>	<b>€(713,215)</b>	<b>€171,100</b>	<b>€ 92,857</b>

\*Parentheses indicate negative numbers

Following are the top level definitions of the different transactions and other economic events that would be reported:

1. **Current-Period Accrual Transactions** (Column 1): Exchange transactions that increase or decrease assets and liabilities in the current reporting period. The items recorded in Column 1 are the traditional accrual transactions, for example, sales revenue, use of labor and other operating services, purchase of raw materials or goods for resale, interest expense, and gains or losses on sales of fixed assets. These transactions must be measured at the gross amounts. Whether a transaction is recorded in this column is not affected by the measurement attribute of the balance sheet account in which they are recorded. Examples of transactions that are recorded in this column include:
  - a. Sales: Sum of (1) the gross amounts recorded to accounts receivable (assumes cash sales are recorded as credit sales with immediate recording of cash collected) and (2) advances from customers
  - b. Interest:
    - i. Expense: Gross increase in amount payable on debt securities
    - ii. Revenue: Gross increase in amount receivable from investments in debt securities
  - c. Tax:
    - i. Expense: Gross increase in amount payable
    - ii. Revenue: Gross increase in amount receivable
  - d. Gain on Sale of Fixed Asset: Gross amount of difference between carrying amount of fixed assets and the cash or other assets received in exchange
2. **Estimates** (Column 2): Nontransaction items that approximate price and other changes of assets and liabilities. Examples of items recorded in the current mixed-attribute model include the following:
  - a. Bad Debt Expense, Sales Returns, and Allowances
  - b. Change in the Balance of Inventory (This estimate is required for calculating Cost of Goods Sold when items are reported by nature rather than function.)
  - c. Deferred Taxes
  - d. Inventory lower-of-cost-or-market write-down
  - e. Current-period stock compensation expense
  - f. Depreciation Expense (an allocation, using any of a variety of methods, of the historical cost of a fixed asset over an assumed useful life)
  - g. Overhead allocations
  - h. Pension Expense, current cost plus allocations of off-balance-sheet deferrals for defined-benefit pensions
  - i. Foreign currency translation effects for assets and liabilities not measured at fair value
  - j. Amortization of bond discounts and premiums
  - k. Interest capitalized
3. **Changes in Fair Value** (Column 3): *Currently in the mixed-attribute model*—Nontransaction valuation adjustments derived from adjusting the carrying amount of an asset or liability (net of related accrual valuation accounts such as Estimated Bad Debts) to its fair value at the reporting date. Examples of such adjustments that would be recorded in the current mixed-attribute model:
  - a. Restoration of LIFO (last in, first out) reserve
  - b. Deferred actuarial gains and losses on defined-benefit pensions
  - c. Foreign currency translation effects for assets and liabilities measured at fair value

*Fair value adjustments*—Amounts required to adjust assets and liabilities that are currently required to be carried at fair value to fair value at the balance sheet date.

- a. Interest rate swap fair value adjustment
- b. Fair value adjustment for securities held for trading

We believe that this new set of financial statements, which reflect our view that fair value is the only relevant measurement attribute, can serve investors well with the current mixed-attribute model and during the period of transition to the fair value model. Moreover, we believe that the proposed Statement of Changes in Net Assets as described can enhance investment decision making throughout this process.

As these adjustments reveal, during the period of transition from the current mixed-attribute model to the fair value model, Column 3, the fair value adjustments column, will include pure current-period fair value adjustments for those items currently carried at fair value in the balance sheet. However, for those items carried at adjusted historical cost, that is, historical cost plus or minus an estimate or allocation such as depreciation, the number recorded in Column 3 will be the amount necessary to adjust the current carrying value to fair value. As additional assets and liabilities are measured at fair value, the estimate and allocation events related to those assets and liabilities will no longer be needed. Consequently, the amount of the fair value adjustment recorded in Column 3 will be the gross amount of the revaluation. For example, we expect the following changes will occur:

1. Accounts Receivable:
  - a. Estimates of uncollectible amounts will no longer be recorded (although full disclosure of the fair value estimation method and assumptions used will be required).
  - b. The amount recorded as the Change in Fair Value will be the total change in fair value from the beginning of the period.
2. Inventory: The change in the inventory balance will be measured and recorded as a Change in Fair Value (Column 3) rather than an Estimate.
3. Fixed Assets:
  - a. Depreciation will no longer be recorded as an Estimates (Column 2); rather, an estimate of the fair value of productive capacity used in the current period will be disclosed separately.
  - b. The Change in Fair Value of Fixed Assets will be the total change in fair value from the beginning of the period.
4. Taxes: The change in the tax liability or asset will be recorded as a change in fair value and reported in the Operating, Investing, and Financing categories as appropriate.
5. Stock Compensation:
  - a. The amount necessary to restate the obligation to fair value will be recorded as a Change in Fair Value.<sup>35</sup>
  - b. The change in fair value from the services provided during this period must be disclosed separately.
6. Foreign Currency Translation: Each effect would be recorded as a change in fair value for the assets and liabilities related to Operating, Investing, and Financing, respectively.

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<sup>35</sup>We are proposing that employee stock options be marked to market at each balance sheet date with the changes in fair value going to earnings each period.

## F. Reconciliation of Balance Sheet, Cash Flows, and Other Changes in Net Assets

Financial statements articulate; that is, the items in the transactions and events statements (currently, the Statements of Income, Cash Flow, Comprehensive Income, and Shareowners' Equity) flow from one to another of the statements, including the balance sheet, and *should* be traceable and directly observable by investors. Indeed, the knowledge gained from analyzing such flows is critical to an investor's understanding of a company's wealth-generation process.

Currently, as we have described in the discussion of the Cash Flow Statement, this articulation is at best obscured, making it impossible for even the most skilled investor to dissect this articulation in order to perform the most basic analyses. The articulation is hidden by (1) the very different and inconsistent aggregation and netting processes in the various statements and (2) the impossibility of directly comparing the operating section of the indirect method cash flow statement with the income statement or the investing and financing sections with changes in the balance sheet. Therefore, we propose to add a completely new statement—the Reconciliation of Balance Sheet, Cash Flows, and Other Changes in Net Assets—to the set of statements shareowners and investors currently receive. We consider this to be pivotal to our goal of increasing the transparency and understandability of companies' financial reporting and disclosures. Although our preference is for the reconciliation to be provided as a required statement, we fully understand that it may be lengthy and, therefore, better positioned as a required supplementary disclosure and fully subject to the auditing standards of the financial statements.

We should not, however, compromise on the presentation of the statement, which should make the disclosures most accessible to investors. The Reconciliation must appear as a single disclosure and must not be disaggregated with separate sections appearing in multiple locations throughout the disclosures. Indeed, disaggregation would subvert the very purpose of the statement.

Arguments about costs of preparation are not relevant to this presentation. The cost is in the data production, all of which is currently available to managers, not the data display. Investors should not be forced to expend additional costs to put the puzzle back together. See Figures 4A and 4B.

Figure 4A. Trans-Global Exports, Ltd., Reconciliation of Balance Sheet, Cash Flows, Accruals, and Valuation Adjustments for Assets

Assets	Balance Sheet 12/31/X3	Transactions/Events	Cash		Valuation Adjustments			Balance Sheet 12/31/X4
			Cash Effect of Prior-Period Accruals	Current-Period Cash Transactions	Accruals	Estimates	Fair Value	
Cash	€4,000,000	Net collections or payments		1,918,411				€ 5,918,411
		Purchase		185,000				
		Change in fair value				11,100		
Marketable securities	€ 0	Cash sales		185,000	0	0	0	€ 196,100
		Credit sales		(250,000)*	250,000			
		Collections		(1,675,000)	2,500,000			
		Bad debt expense	(575,000)				(50,500)	
Net accounts receivable	€ 575,000		(575,000)	(1,925,000)	2,750,000	0	(50,500)	€ 774,500
		Cash purchases		300,000				
		Credit purchases			975,000			
		direct labor			110,000			
		Overhead—depreciation expense, building			100,000			
		Overhead—depreciation expense, lease			5,944			
		Cost of goods sold					(1,937,194)	
Inventory	€ 850,000		0	300,000	1,190,944	0	(1,937,194)	€ 403,750
		Prepayment of rent		120,000				
		Rent expense			(120,000)			
Prepaid rent	€ 0		0	120,000	(120,000)	0	0	€ 0
		Signing of lease contract (or inception)			31,700			
		Depreciation					(5,944)	

Figure 4A. Trans-Global Exports, Ltd., Reconciliation of Balance Sheet, Cash Flows, Accruals, and Valuation Adjustments for Assets (continued)

Assets	Balance Sheet 12/31/X3	Transactions/Events	Cash		Valuation Adjustments		Balance Sheet 12/31/X4
			Cash Effect of Prior-Period Accruals	Current-Period Cash Transactions	Accruals	Estimates	
Leased asset	€0		0	0	31,700	(5,944)	€ 25,756
		Cash purchase of investment		710,000			
		Equity in earnings			12,250		
Investment in affiliates	€0			710,000	12,250	0	€ 722,250
		Capital expenditures		500,000			
		Revaluation of building				160,000	
Buildings	€3,600,000		0	500,000	0	0	€ 4,260,000
		Depreciation expense				(175,000)	
Accumulated depreciation	€ (100,000)		0	500,000	0	0	€ (275,000)
Net buildings	€3,500,000			500,000		(175,000)	€ 3,985,000
Total assets	€8,925,000			500,000		160,000	€12,025,767

\*Parentheses indicate negative numbers

**Figure 4B. Trans-Global Exports, Ltd., Reconciliation of Balance Sheet, Cash Flows, Accruals, and Valuation Adjustments for Liabilities and Equity for the Year Ending 31 December 20X4**

Liabilities	Balance Sheet 20X3	Transactions/Events	Cash		Valuation Adjustments			Balance Sheet 20X4
			Cash Effect of Prior-Period Accruals	Current-Period Cash Transactions	Accruals	Estimates	Fair Value	
		Payment for inventory purchases						
		Cash purchases of inventory		(300,000)	300,000			
		Credit purchase of inventory		(900,000)	975,000			
Accounts payable	€ 850,000		(850,000)	(900,000)	1,275,000	0	0	€ 375,000
		Operating expense			150,000			
		Payments	(28,000)	(72,000)				
Accrued liabilities	€ 28,000		(28,000)	(72,000)	150,000	0	0	€ 78,000
		Collections		200,000				
		Sales			(25,000)			
Advances from customers	€ 15,000		0	200,000	(25,000)	0	0	€ 190,000
		Interest expense on bonds			250,000			
		Payment of interest		(125,000)				
Interest payable	€ 0		0	(125,000)	250,000	0	0	€ 125,000
		Tax expense			75,451			
		Tax payment	(54,639)	0				
Taxes payable	€ 54,639		(54,639)	0	75,451	0	0	€ 75,451
		Dividend declaration			70,000			
		Dividend payment		(35,000)				
Dividends payable	€ 0		0	(35,000)	70,000	0	0	€ 35,000
		Reclassification to current			6,830			
		Interest expense			2,378			
Current portion of lease liability	€ 0		0	0	9,208	0	0	€ 9,208
		Borrowing		500,000				

**Figure 4B. Trans-Global Exports, Ltd., Reconciliation of Balance Sheet, Cash Flows, Accruals, and Valuation Adjustments for Liabilities and Equity for the Year Ending 31 December 20X4 (continued)**

Liabilities and Equity Interests	Balance Sheet 20X3	Transactions/Events	Cash		Valuation Adjustments			Balance Sheet 20X4
			Cash Effect of Prior-Period Accruals	Cash Transactions	Accruals	Estimates	Fair Value	
Short-term debt	€ 0		0	500,000	0	0	0	€ 500,000
		Stock compensation expense			7,500			
Accrued stock compensation	€ 6,000		0	0	7,500	0	0	€ 13,500
		Signing of the lease (or inception)			31,700			
		Reclassification to current			(6,830)			
Lease liability	€ 0		0	0	24,870	0	0	€ 24,870
		Deferred tax expense			33,120			
Deferred tax liability	€ 23,699		0	0	33,120	0	0	€ 56,819
		Pension expense			3,600			
		Contribution	(1,200)					
Accrued pension liability	€ 2,400		(1,200)	0	3,600	0	0	€ 4,800
		Issuance		2,500,000				
		Repurchase or retirement	0					
Bonds payable	€ 0		0	2,500,000	0	0	0	€ 2,500,000
Total liabilities	€ 979,738							€ 3,987,648
Equity interests								
Other equity interests								
Minority interest	€ 100,000							€ 100,000
Perpetual preferred stock	€ 300,000							€ 300,000
Total other equity interests	€ 400,000							€ 400,000

**Figure 4B. Trans-Global Exports, Ltd., Reconciliation of Balance Sheet, Cash Flows, Accruals, and Valuation Adjustments for Liabilities and Equity for the Year Ending 31 December 20X4 (continued)**

Liabilities and Equity Interests	Balance Sheet 20X3	Transactions/Events	Cash		Valuation Adjustments			Balance Sheet 20X4
			Cash Effect of Prior-Period Accruals	Current-Period Cash Transactions	Accruals	Estimates	Fair Value	
Common share-owners' equity								
Common stock	€ 600,000		0	0	0	0	0	€ 600,000
Additional paid-in capital	<u>€4,000,000</u>		0	0	0	0	0	<u>€ 4,000,000</u>
Total common stock	€4,600,000							€ 4,600,000
		Repurchase of stock		0				
		Reissuance of stock	0					
Treasury stock	€ (100,000)		0	0	0	0	0	€ (100,000)
		Net accruals		704,971				
		Net estimation adjustments				(713,215)		
		Net fair value adjustments					171,100	
		Dividend declaration			(70,000)			
Retained net assets	<u>€3,045,262</u>		0	0	634,971	(713,215)	171,100	<u>€ 3,138,119</u>
Total common shareowners' equity	€7,545,262		0	0	1,269,943	(1,426,429)	342,200	€ 7,638,119
Total equity interests	<u>€7,945,262</u>		0	0	1,269,943	(1,426,429)	342,200	<u>€ 8,038,119</u>
Total liabilities and equity interests	<u>€8,925,000</u>							<u>€12,025,767</u>

<b>Figure 5. Trans-Global Exports, Ltd., Journal Entries for the Year Ending 31 December 20X4</b>			
		<b>Dr.</b>	<b>Cr.</b>
<b>1. Pay Rent in Advance</b>			
	Prepaid Rent	120,000	
			Cash
			120,000
<b>2. Cash Purchase of Raw Materials Inventory</b>			
	Inventory	300,000	
			Cash
			300,000
<b>3. Credit Purchase of Raw Materials Inventory</b>			
	Inventory	975,000	
			Accounts Payable
			975,000
<b>4. Payment for Credit Purchases of Inventory</b>			
	Accounts Payable	1,450,000	
			Cash
			1,450,000
<b>5. Cash Sales</b>			
	Cash	250,000	
			Sales Revenue
			250,000
<b>6. Credit Sales</b>			
	Accounts Receivable	2,500,000	
			Sales Revenue
			2,500,000
<b>7. Advances from Customers</b>			
	Cash	200,000	
			Advances from Customers
			200,000
<b>8. Sales—Customer Advances</b>			
	Advances from Customers	25,000	
			Sales Revenue
			25,000
<b>9. Cost of Goods Sold (Based on Estimated Ending Inventory of 403,750)</b>			
	Cost of Goods Sold	1,937,194	
			Inventory
			1,937,194
<b>10. Cash Collections on Credit Sales</b>			
	Cash	2,250,000	
			Accounts Receivable
			2,250,000
<b>11. Compensation Expense</b>			
	Compensation Expense	100,000	
	Inventory—Direct Labor	110,000	
			Cash
			210,000
<b>12. Credit Purchase of Services used in Operations</b>			
	Operating Expenses	150,000	
			Accrued Liabilities
			150,000
<b>13. Cash Payment for Credit Purchase of Services</b>			
	Accrued Liabilities	100,000	
			Cash
			100,000
<b>14. Payment of Interest When Accrued</b>			
	Interest Expense	125,000	
			Cash
			125,000

<b>Figure 5. Trans-Global Exports, Ltd., Journal Entries for the Year Ending 31 December 20X4 (continued)</b>			
		<b>Dr.</b>	<b>Cr.</b>
15.	<b>Purchase of Investment in Affiliates (35 percent)</b>		
	Investment in Affiliate	710,000	
	Cash		710,000
16.	<b>Dividends Declared</b>		
	Retained Net Assets	70,000	
	Dividends Payable		70,000
17.	<b>Dividends Paid</b>		
	Dividends Payable	35,000	
	Cash		35,000
18.	<b>Used Rental Space</b>		
	Rent Expense	120,000	
	Prepaid Rent		120,000
19.	<b>Depreciation Expense—Building</b>		
	Inventory	100,000	
	Depreciation Expense	75,000	
	Accumulated Depreciation		175,000
20.	<b>Accrual of Interest at Year End</b>		
	Interest Expense	125,000	
	Interest Payable		125,000
21.	<b>Bad Debt Expense</b>		
	Bad Debt Expense	50,500	
	Allowance for Uncollectibles		50,500
22.	<b>Tax Expense</b>		
	Tax Expense	108,571	
	Tax Payable		75,451
	Deferred Tax Liability		33,120
23.	<b>Revaluation of Building to Fair Value</b>		
	Building	160,000	
	Change in Fair Value		160,000
24.	<b>Signing of Lease Contract (January)</b>		
	Leased Asset	31,700	
	Lease Liability		31,700
25.	<b>Inception of Lease (April)</b>		
	Lease Liability	6,830	
	Current Portion of Lease Liability		6,830
26.	<b>Interest Accrual on Lease Liability (75 percent of 3,170)</b>		
	Interest Expense	2,378	
	Current Portion of Lease Liability		2,378
27.	<b>Inventory and Amortization of Leased Asset (75 percent of 7,925)</b>		
	Inventory	5,944	
	Accumulated Depreciation of Leased Asset		5,944
28.	<b>Capital Expenditure on Building</b>		
	Building	500,000	
	Cash		500,000

<b>Figure 5. Trans-Global Exports, Ltd., Journal Entries for the Year Ending 31 December 20X4 (continued)</b>			
		<b>Dr.</b>	<b>Cr.</b>
29.	<b>Issuance of Short-Term Debt</b>		
	Cash	500,000	
	Short-Term Debt		500,000
30.	<b>Issuance of Bonds</b>		
	Cash	2,500,000	
	Bonds Payable		2,500,000
31.	<b>Purchase of Marketable Securities (Held for Trading)</b>		
	Marketable Securities	185,000	
	Cash		185,000
32.	<b>Dividends Received (Marketable Securities)</b>		
	Cash	9,250	
	Dividend Income		9,250
33.	<b>Change in Fair Value</b>		
	Marketable Securities	11,100	
	Change in Fair Value		11,100
34.	<b>Award of Stock Compensation</b>		
	Compensation Expense	7,500	
	Accrued Stock Compensation		7,500
35.	<b>Pension Expense</b>		
	Pension Expense	3,600	
	Accrued Pension Liability		3,600
36.	<b>Pension Contribution</b>		
	Accrued Pension Liability	1,200	
	Cash		1,200
37.	<b>Equity in Earnings of Affiliate (35 percent of 35,000 = 10,500)</b>		
	Investment in Affiliate	12,250	
	Equity in Earnings of Affiliate		12,250
38.	<b>Payment of Taxes</b>		
	Tax Payable	54,639	
	Cash		54,639

**Figure 6. Trans-Global Exports, Ltd., Accounting for Interest Rate Swap—Example of Fair Value Reporting for the Year Ending 31 December 20X4**

**Terms**

The company purchases a \$10,000 bond with a fixed interest rate of 8 percent and wishes to hedge its fair value against an increase in interest rates. After significant investigations, it purchases an interest rate swap that converts the investment to floating.

Notional amount:	\$10,000
Pay Fixed Rate:	8 percent
Receive Floating Rate:	6 month LIBOR plus 175 bps
Effective Date:	January
Maturity:	5 years
Frequency of Settlement:	Semi-annual
Day Count	180/360

<b>Journal Entries</b>		<b>Dr.</b>	<b>Cr.</b>
31 December 20X3	<b>Purchase of Bonds</b>		
	Bonds Available for Sale	10,000	
	Cash		10,000
	<b>Enter Into Swap Contract When LIBOR Is 5.85 Percent</b>		
	No Entry		
30 June 20X4	LIBOR Is 7.91 Percent		
	Effective Interest on the 4.5-Year Bond Is 9.66 Percent		
	<b>Mark Swap to Market</b>		
	Swap Asset	694	
	Change in Fair Value (Statement of Changes of Net Assets)		694
	<b>Mark Bond to Market</b>		
	Change in Fair Value	713	
	Bonds Available for Sale		713
	<b>Coupon Interest Earned</b>		
	Interest Receivable	400	
	Interest Income (Statement of Changes in Net Assets)		400
	<b>Collect Coupon Interest</b>		
	Cash	400	
	Interest Receivable		400
	<b>Swap Cash Flow</b>		
	Interest Income (Current-Period Accrual) (Statement of Changes in Net Assets)		
	Swap Asset	19	
	Cash		20
31 December 2004	LIBOR Is 6.98 Percent		
	<b>Amortization of Bond Discount from Last-Period Write-Down</b>		
	Bond Discount	64	
	Interest Income (Allocation) (Statement of Changes in Net Assets)		64
	<b>Mark Swap to Market</b>		
	Change in Fair Value (Statement of Changes in Net Assets)	331	
	Swap Asset		331
	<b>Mark Bond to Market</b>		
	Bonds Available for Sale	315	
	Change in Fair Value (Statement of Changes in Net Assets)		315
	<b>Earn Coupon Interest</b>		
	Interest Receivable	400	
	Interest Income (Current-Period Accrual) Statement of Changes in Net Assets		400

**Figure 7. Effects of Interest Rate Swap on Reconciliation of Balance Sheet, Cash Flows, Accruals, and Valuation Adjustments**

Assets	12/31/X3	Transaction/ Event	Cash		Accruals	Valuation Adjustments		12/31/X4
			Cash Effect of Prior-Period Accruals	Current- Period Cash Transactions		Estimates & Allocations	Change in air Value	
		Collect Coupon		\$400				
		Swap Cash Flow		(20)				
<b>Cash</b>	<b>0</b>			<b>380</b>				<b>\$ 380</b>
		Earn Coupon			\$800			
		Collect Coupon		(400)				
<b>Interest Receivable</b>	<b>0</b>			<b>(400)</b>	<b>800</b>			<b>400</b>
Bonds Available for Sale	<b>10,000</b>							<b>10,000</b>
		Mark Bond to Market [(713)+315]					\$(398)	
		Amortization				\$64		
Bond Discount	<b>0</b>					<b>64</b>	<b>(398)</b>	<b>(334)</b>
<b>Net Bonds</b>	<b>10,000</b>							<b>9,666</b>
		Mark Swap to Market [694+(331)]					363	
		Swap Cash Flow		19				
<b>Swap Asset</b>	<b>0</b>			<b>19</b>			<b>363</b>	<b>382</b>
<b>Retained Net Assets</b>	<b>10,000</b>					<b>64</b>	<b>(35)</b>	<b>10,828</b>

**Figure 8. Statement of Changes in Net Assets Available to Common Shareowners**

		Current- Period Accrual Transactions	Estimates & Allocations	Fair Value Adjustments	Change in Net Assets
<b>Investing Activities</b>	Interest Income & Interest Rate Swap (FV Hedge)	(1)		\$363	\$364
	Interest Income & Available for Sale Bonds	\$800	\$64	(398)	466

## Chapter 4. Financial Statements and Disclosures

*In general, the lower the reliability of an amount in the financial statements, the greater is the need for the financial statements to explain the basis on which the amount was arrived at, including the principle assumptions used, the reasons those assumptions were selected, and the impact that changes in those assumptions would have on the financial statements.*<sup>36</sup>

### A. What Is Disclosure?

Disclosures provided in conjunction with financial statements are essential to an investor's understanding and analysis of the economics underlying the information contained in the statements. We use the term "disclosures" broadly to include the footnotes to the financial statements, management's discussion and analysis of operations and financial position (which is required disclosure in a number of regulatory jurisdictions), and other required disclosures, such as information about the company's competitive environment, risk exposures, and legal liabilities and contingencies.<sup>37</sup>

Our concept of disclosure, however, is wider and more comprehensive than the material that traditionally appears in the audited footnotes and other required filings. All of the captions and display choices in a company's Annual Report to Shareowners or regulatory reporting documents, and the Letter to Shareowners, whether audited or not, constitute disclosure in our view. We firmly believe that the principles of transparency, consistency, and completeness, along with an intention to communicate clearly, must form the basis for disclosure elements wherever they are found.

Investors require sufficient disclosure to be able to understand and properly evaluate changes in the wealth of the company, the quality of reported earnings and other financial statement metrics, and to make forecasts about the future prospects of the company. In this chapter, we will discuss the types of disclosures investors need and will propose new disclosures that will help us to better meet these needs.

A protest that is frequently launched, either when additional disclosures are sought by investors or when standard setters propose to require them, is that investors are already overloaded with disclosures and cannot suffer the burden of any more. We would hasten to assure standard setters that useful information is never overload. Indeed, investors cannot properly conduct their analyses and make their financial investment decisions without it.

Overload, which we would describe as useless information, comes from several sources. First among the sources is so-called boilerplate information, disclosure that has had every iota of economic essence carefully excised and that does not change from year to year, except for the occasional substitution of a new number or two. A second source of useless information is redundant disclosure—that is, information that may or may not otherwise be useful but that occurs in the exact same form in two or more places in the same financial statements. Investors only need to be told the same thing once.

A third type of useless information is that which is overly condensed and appears to provide quantitative or other detailed information while, in fact, providing little or nothing of substance. For example, some companies have been known to offer as disclosure something similar to: "Our various classes of fixed assets are depreciated using a variety of methods, including straight line, sum-of-the-years' digits, and several declining balance methods, with estimated useful lives ranging from 5 to 40 years." Investors will not find much use for such

<sup>36</sup> "How Fair Is Fair Value?" *IFRS Stakeholder Series*, EYGM Limited, London, May 2005, p. 3.

<sup>37</sup> Other materials typically provided in the annual report, such as the manager's letter to shareowners, *can* provide interesting and useful insights, particularly if managers are forthcoming in their discussions of important matters affecting corporate performance and outlook. Such discussions, however, are sometimes used by managers to serve their own interests rather more than those of shareowners, for example, by providing a biased view of the reasons for poor performance. In addition, these items are generally not reviewed for accuracy by the auditors.

disclosure. A fourth type of problematic disclosure is otherwise useful information that has been embedded in multiple pages of otherwise uninformative prose. Wherever possible, disclosures should be provided in tables, charts, or other concise templates that minimize both investors' search efforts and the company's expenditure of resources.

## B. Disclosure Objectives

A particular number reported in the financial statements can be decomposed into two parts: (1) the pure economic effects of an event or transaction on the company's operations and financial position and (2) the effects of the financial reporting methods that managers have chosen to use on the recognition and measurement attributes of the item. Ultimately, investors want to be able to understand and evaluate the economic position of the company and changes in that position. If investors are to be able to understand the economics, then they must first be able to disentangle the economic effects from the artifacts of the financial reporting methods used. Thus, a principle objective of disclosure must be to provide investors with the information they need to make this distinction.

Disclosures must provide investors with all of the additional information they need to place the financial statement numbers in their economic context. Examples of such information might include the sensitivities of the reported numbers to the methods, models, and assumptions used; risk exposures associated with the number; any contingencies and other factors associated with the number; and similar information.

Thus, if disclosures are to be useful for financial decision making, they must provide all of the information investors need. At a minimum, this information must enable investors to fully understand:

1. Managers' accounting policy choices;
2. The methods and valuation models (including assumptions, inputs, and other judgments) managers have used to implement the policy choices;
3. How these decisions have affected the recognition and measurement of individual financial statement items;
4. How they have affected the amounts and timing of items recognized in the financial statements;
5. What degree of uncertainty is associated with individual measurements;
6. How to disaggregate the reported financial statement information into components that:
  - a. Exhibit different economic characteristics and trends; and that
  - b. Have differential and sometimes offsetting effects on the financial statements;
7. How the company's risk exposures, including market, price, currency, and event risk, might affect the company's operations and financial position;
8. How economic assets and liabilities that are not reported in the financial statements may affect the company's operations;
9. How the nonfinancial drivers influence financial statement results;
10. The implications of the economics for the investor's forecasts of future events; and
11. How the investor's event forecasts will affect forecasts of financial statement components.

## C. Criteria for the Development of Effective and Useful Disclosures

For disclosures to best serve investors' needs, they must meet a number of criteria to be applied both when standard setters are developing them and when managers are applying them to their companies' operations. We will consider each of these in turn.

### 1. Disclosure Is Not a Substitute for Recognition and Measurement, and Recognition and Measurement Do Not Remove the Need for Disclosure.

Although we have tried to make clear that recognition and measurement of items in the financial statements do not obviate the need for disclosure, we must make a special point of this. All too often in the past we have found that when new financial reporting standards are proposed, the exposure drafts address the basic provisions for recognition and measurement and also propose extensive supplementary disclosures that provide the additional information investors need to evaluate the reported numbers. But despite investors' expressed support for the disclosures, the disclosures tend to disappear from the final standard. An example is the transition from several pronouncements, including FASB Statement No. 80, *Accounting for Futures Contracts*, to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Much of the information essential for understanding and interpreting the recognition methods, including where gains and losses are reported in the statements, was deleted in the final standard. Similarly, when financial reporting standards move from full disclosure in the footnotes to recognition in the statements, the related disclosures frequently disappear. It is essential that in the future, the quality, relevance, and completeness of required disclosures be given the same priority in standard setting as the recognition and measurement requirements.

### 2. Standards for Recognition and Measurement of Financial Statement Items and Their Related Disclosures Must Be Developed Concurrently.

As the prior section makes clear, disclosures must:

- Clarify how the financial statement numbers have been generated;
- Provide the additional information investors need to evaluate all of the implications of this process; and
- Provide the information investors require to understand the economic context for the numbers.

Thus, a particular standard and its related disclosures are inseparably linked. Both the amounts and the types of disclosures must be driven by the recognition and measurement provisions of the standard itself. For example, if an item is required to be measured at fair value in the balance sheet and the income statement, the minimum disclosures must include the method managers have used to determine the fair value and the sensitivity of that value to changes in market events. If the fair value is determined by estimation using a widely accepted market model, that model must be disclosed along with the assumptions and inputs managers used in the estimation and the sensitivity of the estimates to changes in the inputs.

### 3. Policy Choices, Assumptions, Judgments, and Methods Must Be Fully and Clearly Disclosed.

Every financial statement item—even cash and cash equivalents—incorporates estimates. These estimates are a direct function of managers' assumptions and judgments and affect not only an item's measurement but also whether it is recognized at all. Hence, disclosure about these assumptions and judgments is essential if investors are to understand the financial statements and their implications. With sufficient disclosure, investors can make their own assessments about these assumptions and judgments so that, when necessary, they can make changes to reported amounts that better reflect their own expectations. More importantly, however, disclosure permits investors to make better forecasts of future results.

Disclosure also allows investors to evaluate managers and their performance. For example:

- Are the managers' accounting choices investor-friendly?
- Do the choices contribute positively to earnings quality?
- Is the result greater recognition or less, etc.?
- Do the choices result in greater transparency, completeness, consistency, and clarity?

### 3.1 Accounting policies

Many accounting standards allow managers to choose from a menu of several alternative accounting methods for economically similar transactions. In general, the alternatives were intended to provide managers with a degree of flexibility so that they could better reflect the economic substance of events and transactions. These alternatives, however, can and have led to widely different recognition and measurement outcomes for the same economic event.

Unfortunately, managers all too often have used the flexibility not to better reflect the economic substance of transactions but rather to structure transactions to achieve a particular accounting result. The SEC recently made clear its views on the misuse of accounting choices, particularly with regard to off-balance-sheet arrangements.

*The Staff identified several key initiatives to improve transparency in reporting, as follows:*

- i. Discourage transactions and transaction structures primarily motivated by accounting and reporting concerns, rather than economics. *The Staff believes that use of transaction structuring to achieve accounting and reporting goals that do not conform to the economic substance of the arrangements reduces transparency in financial reporting. As discussed below, many of the areas dealing with off-balance sheet arrangements involve significant use of accounting-motivated structured transactions.*<sup>38</sup> [Emphasis supplied]

Such misuse of the choices can have significant effects on the financial statements and the measures of performance. Whether managers capitalize or expense, recognize contingent liabilities or other net asset changes directly in earnings, or defer them in equity affects when transactions and events are recognized and how they are measured. Each choice affects the information provided in the financial statements and, consequently, has implications for analysis and investment decision making. Therefore, disclosure of the accounting policies managers have selected, the rationale for making each choice, the consistency of those choices, and the relative effects of the choices on the financial statements are essential disclosures. Current accounting policy disclosure requirements are generally inadequate in this regard.

Although GAAP currently requires disclosure of accounting policies and that those policies be followed consistently, disclosure of the rationale for making each choice is not currently required. We believe that the type of disclosure proposed by the SEC in 2002 for critical accounting policies should be required. The SEC proposed that if

1. the application of an accounting policy required assumptions about matters that are highly uncertain and
2. a different assumption could reasonably have been chosen and
3. if chosen would have had a material impact on the company's financial position or its results of operations
4. then the following should be provided:
  - basic disclosures needed to understand the accounting estimate
  - discussion of changes to the estimate that would result from both:
    - a reasonably possible near-term change in the assumption underlying the estimate and

<sup>38</sup> Report and Recommendations Pursuant to Section 401(c) of the Sarbanes–Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, U.S. SEC, 15 June 2005, p. 7.

— use of the ends of the range of reasonably possible amounts.<sup>39</sup>

### 3.2 Assumptions, judgments, and methods: example—disclosures for defined-benefit pension plans

An employer bears significant operating and investment risk when it commits to providing a specific amount of postemployment benefits under a defined-benefit pension plan. In recent years, the debt represented by companies' defined-benefit pension plan promises to employees has been a major factor in a number of corporate bankruptcy filings.<sup>40</sup> Thus, pension reporting provides an excellent illustration of why investors' decisions are critically dependent on clear and complete disclosure. An investor must be able to fully understand the company's economic obligation under the plan, the investment risk it faces, and its ability to meet its obligations.

This analysis would not be possible without the disclosures required by SFAS No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.<sup>41</sup> Despite recent improvements made with the intent to converge IAS requirements with those in SFAS No. 132, fewer disclosures are required by IAS No. 19, *Employee Benefits*, than are required under U.S. GAAP. As a result, investors still cannot perform the analysis necessary to understand the pension obligations of companies reporting under IAS. Hence, we recommend that the IASB continue to improve IAS No. 19 as part of its convergence project with the FASB.

The pension reporting example also allows us to illustrate why clear and complete disclosure of managers' assumptions and judgments is so important and how investors use these disclosures to evaluate companies' pension obligations. Although SFAS No. 87 requires managers to use the same actuarial method to calculate their benefit obligations, they have considerable flexibility in selecting the actuarial assumptions or inputs to the valuation process. This can result in a wide variation in assumptions across companies. What might not be so obvious, however, is the wide range of variability frequently found in these assumptions for the same company over time.

The assumptions, and any changes in them, can affect the measurement of the pension obligations, sometimes significantly. Managers must make assumptions about mortality rates, retention (or attrition) rates, retirement ages, and the like that will affect the estimated future payout to employees. Disclosure is not required for any of these assumptions. Fortunately, SFAS No. 87 does require that companies disclose three key assumptions: (1) the discount rate, (2) the rate of increase in compensation, and (3) the expected long-term rate of return

<sup>39</sup>U.S. SEC Release 33-8098, 14 May 2002. This Release reads in part:

*In December 2001, the Commission released FR-60 and indicated that companies should provide more discussion in MD&A about their critical accounting policies. Under an appropriate heading, companies are encouraged to disclose their most difficult and judgmental estimates, the most important and pervasive accounting policies they use, and the areas most sensitive to material change from external factors, and to provide a sensitivity analysis to facilitate an investor's understanding of the impact on the bottom line.*

*In our review of the Fortune 500 companies, we noted a substantial number of companies did not provide any critical accounting policy disclosure in circumstances where FR-60 could fairly be read as calling for this disclosure. We also found that the critical accounting policy disclosure of many companies did not adequately respond to the guidance provided in FR-60. We also found that many companies failed to provide the sensitivity analysis the Commission encouraged in FR-60.*

*Many of the areas identified below could have been made more transparent as a result of a more thoughtful discussion of assumptions and estimates. We found that we asked many companies to enhance their disclosure of critical accounting policies in one or more of the following areas:*

- Revenue recognition;
- Restructuring charges;
- Impairments of long-lived assets, investments and goodwill;
- Depreciation and amortization expenses;
- Income tax liabilities;
- Retirement and post retirement liabilities;
- Pension income and expense;
- Environmental liabilities;
- Repurchase obligations under repurchase commitments;
- Stock based compensation;
- Insurance loss reserves; and
- Inventory reserves and allowance for doubtful accounts.

<sup>40</sup>See, for example, "How Wall Street Wrecked United's Pension," *New York Times*, 31 July 2005.

<sup>41</sup>The accounting for defined-benefit plans is covered by SFAS No. 87, *Employers' Accounting for Pensions*.

on plan assets. The discount rate has the greatest effect on the measurement of the reported obligation: Decreases in the rate increase the obligation (and vice versa), an effect that is magnified with long periods of compounding. With disclosure, investors can compare the discount rate with general interest rate levels and rates used by competitors, evaluate whether the obligation is likely to be over- or undervalued, evaluate the amount of pension expense recognized, and assess whether the rate and changes in it are appropriate. An investor can use this information as a starting point for preparing forecasts of future changes in the obligation and the related pension cost.

#### **4. Disclosures Should Provide Sufficient Disaggregated Information for Investors to Be Able to Fully Understand and Interpret the Summary Information in the Financial Statements.**

To be useful to a wide spectrum of stakeholders, the financial statements must be presented at a high level of aggregation. Summary reports are useful to the extent that they provide an overall picture of the company's financial position. Any conclusions, however, an investor can draw based upon such highly aggregated information are necessarily conditional upon the investor's ability to gain a deeper understanding of the company's underlying economics. This information must be obtained from the disaggregated disclosures in the footnotes. Such essential disclosure helps us to better evaluate the different financial statement elements and cash-generating processes that exist within a company.

##### **4.1. Aggregation process**

Investors need to understand how managers aggregate information. At a minimum, we need answers to the following questions:

1. Do managers combine items that have different trends or that are affected by different economic variables or conditions? These distinctions, and the information embedded in them, are lost in aggregation. Investors need to be able to separate financial statement items into these differing components so as to forecast the items more precisely and accurately.
2. Do managers make different accounting policy choices for items of similar economic substance? What economic rationale do the managers provide for the different treatments? Are the justifications plausible, or do they seem designed to achieve particular accounting outcomes at the expense of transparency?

##### **4.2 Example: disclosures for the revenue-generating process**

We provide an example of the type of detailed disclosures that investors find useful in understanding the highly summarized and aggregated information associated with the revenue-generating process. Indeed, a substantial proportion of the investors' financial statement analyses are performed solely to generate such information. Moreover, were managers to follow the reporting model that we have outlined in Chapter 3, the major components of the quantitative disclosures in the table would already be available and readily accessible to investors.

A careful study of the disclosures in this example, particularly those provided in the table, will make clear the inseparable linkage between a given reporting standard or standards and their related disclosures.

## PROPOSED DISCLOSURES: REVENUE RECOGNITION

### I. Qualitative Disclosures:

1. SEC MD&A:
  - a. Major sources or categories of revenues.
  - b. Trends in revenues by major category and reasons for the changes.
  - c. Competitive factors affecting the revenues.
  - d. Risks and risk exposures that could affect revenues in the future.
2. Accounting recognition methods used, changes in the methods, and the effects on revenue and operating income of the changes.
3. For each revenue recognition method used, disclosure of the revenue and operating income produced by that method, and the segment or segments where that revenue and operating income is reported.
4. Segment Disclosures—See Section II on the next page.
5. Reconciliation of the allowance for sales returns and allowances: beginning balance, operating charges, foreign currency effects, effects of acquisitions and divestitures, and ending balance.
6. Reconciliation of bad debt provisions: beginning balance, new provisions booked/net provisions charged to income, provisions reversed, provisions used, effects of acquisitions and divestitures, ending balance.
7. For lease arrangements of all types, disclosure of the weighted-average length of contract life for each type of lease revenue recognized each quarter.
8. Weighted-average life of deferred revenue, also provided quarterly.
9. For revenue recognized under percentage-of-completion methods, the amount of revenue recognized using (1) output-related measures (e.g., methods based on units produced) and for (2) input-related measures (e.g., cost-to-cost methods).
10. Difference between the nominal and the fair value of receivables, the implied interest.
11. Revenue from barter transactions, interest, royalties, and dividends.
12. Amounts of revenue transferred from one period to another, for example, by structured finance or internal reorganizations.

## II. Quantitative Disclosures:

### RECONCILIATION OF RECEIVABLES AND REVENUES BY MAJOR REVENUE SOURCE

Disclosures	Major Revenue Source 1	Major Revenue Source 2	Major Revenue Source 3	Total
Accounts receivable, beginning balance				
+ Revenues recognized (current-period sales)				
+ Deferred revenues <sup>a</sup>				
Cash collected—current-period revenues				
Cash collected—prior-period revenues				
+ Purchased/acquired receivables				
Sales/divestitures of receivables				
Reclassifications				
Write-offs				
+ /Fair value adjustment				
Accounts receivable, ending balance				

<sup>a</sup> This line will enable analysts to calculate the days-sales-in-receivables ratio. Increasingly, sellers' contractual arrangements for sales to distributors and others result initially in the recognition in the balance sheet of a receivable and deferred revenue. Revenue is not recognized until the product is sold to a third party, and frequently cash is not remitted to the seller until the final sale is completed.

#### 4.3 Consolidation process

Consolidation represents the ultimate in information aggregation. Whether a company fully consolidates subsidiaries, reports a so-called “one-line consolidation” using the equity method, or chooses proportional consolidation to incorporate its significant investments, investors are disadvantaged in their analyses. Each of these accounting methods poses different challenges to financial analysis. Disclosures must provide the disaggregated information investors require to understand the differing risk and reward characteristics of each investment and how each contributes to the overall performance of the company.

One of the problems that investors face in analyzing consolidated financial statements is the underlying assumption that all of the assets and liabilities of the consolidated company are controlled by and available to the parent company, and hence, to its shareowners. Where this assumption does not accurately reflect the economics of the parent's ownership position, disclosures must provide the information investors need to understand the position. Another difficulty is that consolidation combines companies with different operating activities and capital structures and can obscure their different economic characteristics. This is especially problematic with consolidation of the cash-generating processes of different divisions. Severe problems in one division can be masked by the strong cash-generating activities in another.

These problems are exacerbated when the company consolidates nonhomogeneous subsidiaries or joint ventures. Use of the equity method further obscures the substance and economics of an investment, especially for jointly controlled companies. In fact, as noted in White, Sondhi, and Fried, “[D]epending upon the financial characteristics of the subsidiary, consolidation may result in financial statements that look better or worse than those resulting

from use of the equity method.”<sup>42</sup> Without significant disaggregated information, investors are at an extreme disadvantage in their attempts to understand, for example, the cash-generating ability of the company and its subsidiaries.

It is particularly important to recognize that the decision to fully consolidate a subsidiary, or to report its activities under a different accounting method, affects cash even when traditional accrual accounting measures may be the same. Consolidated financial statements will include total cash inflows and outflows from the consolidated subsidiary with the parent’s cash flows. This will increase or decrease a critical indicator used by investors, cash from operations (CFO), metrics based upon CFO such as free cash flow, and the other components of the cash flow statement and their metrics. In contrast, investments reported using the equity method only show cash flows to or from the unconsolidated subsidiary, such as dividends and additional investments. In the latter case, investors can be misled, or at least disadvantaged, if they do not have sufficient information to restate cash from operations so that they can fully understand the company’s cash flows, its cash-generating ability, and the cash available to current shareowners.

#### 4.4 Segment disclosures

Investors face major challenges when analyzing companies with multiple lines of business or that operate in different countries with the consequent differences in legal, regulatory, and tax regimes. Consolidated financial statements aggregate the financial data of subsidiaries and/or divisions not only with different economic fundamentals—financial structures, line of business and risk attributes—but also with potentially different financial reporting policies and practices.<sup>43</sup>

Although there is evidence that the information currently required and reported has improved over that which was previously provided, we believe that it is important that standard setters continue efforts to enhance and refine disclosure requirements.<sup>44</sup> Significant limitations in the data need to be addressed when standard setters next consider segment reporting. Four key limitations have been identified by White, Sondhi and Fried:

1. Insufficient information is provided about segment liabilities, especially non-interest-bearing liabilities such as payables and accruals, as well as off-balance-sheet obligations.
2. The computation of segment profit is affected by intersegment pricing and overhead allocations.
3. Differences in accounting policy choices across segments can also affect comparability.
4. In general, cash flow data are not provided for segments.

The combination of inadequate information about liabilities coupled with no information about cash flows makes it difficult for investors to assess capital allocation across segments, for example, which segments are net cash flow generators and which are net users of cash and, therefore, require cash infusions from the parent.

With reservations, we continue to support the management approach to the identification of reportable segments. We believe that this approach can provide investors with valuable insights into the sources of past, present, and future earnings as well as relevant risk factors. We remain concerned, however, about the potential for managers to obscure important

<sup>42</sup>White, Gerald I., CFA, Ashwinpaul C. Sondhi, and Dov Fried, *The Analysis and Use of Financial Statements*, Third Edition, Wiley (New York), 2003, p. 475

<sup>43</sup>See Comment Letter of the Financial Accounting Policy Committee to the Financial Accounting Standards Board and the International Accounting Standards Committee on *Reporting Disaggregated Information about a Business Enterprise and Reporting Financial Information by Segment*, respectively, 24 June 1996.

<sup>44</sup>Venkataram, R. (2001), in his unpublished dissertation “The Impact of SFAS No. 131 on Financial Analysts’ Information Environment,” found evidence that, on average, the accuracy of analysts’ earnings forecasts improved after the introduction of SFAS No. 131.

information by selectively aggregating units with fundamentally different economic or operating characteristics. We are also concerned that managers may tend to define segments based upon legal structure rather than their economic and operating characteristics. The most useful segment information for investors is that based upon economically similar or related product lines or geographic factors. We would support an amendment to the standards that requires managers to disaggregate segments that combine operations with disparate economic characteristics.

We also continue to be opposed to bright line significance tests and recommend that standard setters consider requiring disclosure of segment information for any segment that is significant to managers, for example, a segment that reports as such internally to the chief decision maker, including vertically integrated segments.

#### **4.5 Disclosures about major customers and suppliers**

When a single customer, or a small group of principal customers, represents a significant portion of a company's business, the company and its investors may be exposed to substantial risk. This risk may result from a customer's taking this business to a competitor, from financial deterioration of the customer's business, or from a decision to exit the business altogether. Similarly, reliance on a sole supplier or a small number of vendors, particularly when the goods or services supplied are essential to a company's operations, can expose the company to the risks of interruption or even cessation of major products or services, to rapid increases in prices for critical inputs, and to other hazards.

Information about such customers and suppliers and the risks investors face is essential to an analysis of a company. Consequently, as part of the convergence of U.S. and international GAAP, we would like to see enhanced disclosure about major customers and suppliers. We recommend that all standard setters require disclosure of the amount of revenue or inputs from such customers and vendors and the segment(s) affected. Indeed, we believe such arrangements are similar in some important ways to related party transactions. Thus, disclosures similar to those for related parties should be required.

### **5. Risk Disclosures.**

Companies are exposed to a multitude of risks. Among managers' key responsibilities are managing risk exposures consistent with the company's business plan and protecting the company and its investors from the possible adverse effects of risks the company does not wish to bear. It is important to observe here that some strategies may call for increasing the company's exposure to risk in the expectation of realizing higher returns. In order to achieve these objectives, managers may choose to enter into contracts or other financial arrangements that either reduce or increase operational risks and uncertainty about future outcomes. A by-product of some risk management strategies is that arrangements designed to reduce exposure to one type of market risk may increase the company's exposure to other risks. For example, a variable-to-fixed interest rate swap may eliminate the uncertainty about future interest expense but will expose the firm to additional counterparty risk as well as the risk of future changes in the fair value of the debt.

Without clear and complete disclosure of a company's risk exposures, its plans and strategies for bearing or mitigating those risks, and the effectiveness of its risk management strategies, investors will be unable to evaluate either the company's risks and rewards or its future expected outcomes. In the following section, we discuss briefly what information is essential for investors to be able to understand a company's risk exposures and risk management policies and activities.

#### **5.1 Sensitivity analysis**

Among the disclosures that investors find most useful is analysis of the sensitivity of financial statement measurements to underlying assumptions and modelling methods. Unfortunately, these analyses are rarely provided in a clear and effective manner. Effective disclosure of assumptions and judgments allows investors to understand how sensitive reported

measurements are to changes, deviations, or errors in the inputs. Investors need to know which assumptions are central to an estimate. They also need to know the isolated effect of a single assumption on the estimate and how changes in one assumption might affect other assumptions, that is, how they interact. We also need to know which assumptions result in nonlinear effects and what the limits might be to such effects.

We believe that investors are best served when managers provide sufficient information about the estimation model or process and the key inputs and assumptions so that investors can construct a reasonable model of the measurements. Then, investors can perform additional sensitivity analyses by changing the assumptions consistent with their own expectations and observing the effects. The information also permits investors to forecast future financial statement and cash flow effects when key inputs, such as interest rates, prices, and exchange rates, change between reporting periods. Such disclosure has the additional benefit of increasing investor confidence in the financial statements as a whole, particularly when clear and understandable sensitivity analysis is provided for key risk areas.

In our 1996 comment letter to the SEC proposal “Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information about Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments,” CFA Institute was explicit in its preference that companies be required to provide sensitivity analyses for financial instruments and derivative instruments. We explained that when these analyses are properly constructed and clearly disclosed, the resulting information is superior to value at risk (VAR) disclosures. The disclosures should “quantify the potential loss in earnings, fair values, or cash flows from hypothetical changes in market rates and prices.”<sup>45</sup> In this letter, we also provided a (nonexhaustive) list of standard stress tests that we believe should be performed routinely by companies and disclosed to investors:

1. 15 percent or 100 basis point (whichever is greater) adverse interest rate shift along the entire yield curve;
2. 15 percent or 100 basis point (whichever is greater) adverse interest rate shift at the long end (over seven years) and short end (under seven years) of the yield curve relative to the rest of the curve;
3. 50 basis point adverse quality spread change relative to relevant government securities;
4. 10 percent adverse change in any currency in which the company has a 10 percent or more asset or earnings exposure;
5. 20 percent adverse change in any currency in which the company has 5 percent or more of its revenues or in which it has 10 percent of its competitive capacity;
6. 15 percent adverse move in a portfolio(s) that is long in equity instruments; and a
7. 2 annualized standard deviation or 20 percent (whichever is greater) price change in any physical commodity that has a material impact on the company’s operations.<sup>46</sup>

In addition, we believe that managers should provide investors with information about what are sometimes termed catastrophe or disaster risks, for example, what type of price or interest rate change would be required to reduce the value of assets to zero or to make it impossible for the company to meet or refinance its obligations. Even if the possibility of such change is remote or unlikely, such information is a very useful supplement to an investor’s own forecasts of interest rate or price movements.

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<sup>45</sup> Comment Letter from the AIMR Task Force on Market Risk Disclosures to Jonathan G. Katz, Secretary, U.S. SEC, regarding “Proposed Amendments to Require Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Qualitative and Quantitative Information about Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments,” 20 May 1996, p. 5.

<sup>46</sup> Ibid, p. 6.

## 5.2 Exposure to exchange rate risk

Multinational, or perhaps more appropriately globally diversified, companies conduct operations in a number of countries. This complicates our analysis by introducing nonfinancial considerations, for example, legal, regulatory, and political factors, that can significantly affect the economic and financial position of the company. Although those considerations may not be discussed in the financial statements *per se*,<sup>47</sup> the introduction of even one additional currency with resulting exchange rate fluctuations can have a significant effect on the reported financial statements as well as the actual performance and financial position of the company in the current and future periods. When companies operate with a basket of currencies, the analysis becomes exceedingly complex. Investors in every market face the same challenges in analyzing and valuing these companies. Adequate information is critical if capital is to be allocated most efficiently and effectively to both companies and markets.

In analyzing the consolidated financial statements of globally diversified companies, as White, Sondhi, and Fried explain, “the ultimate objective is to understand the firm’s economic exposure to exchange rates, the effects of rate changes on this exposure, and whether or not the effects reported in financial statements reflect the economic effects appropriately.” Because the financial statements report information in a single currency, investors must rely upon the disclosures to gain needed insight and understanding.

Investors require a number of disclosures to gain a comprehensive understanding of exchange rate effects. These disclosures include:

1. Translation gains and losses, preferably disaggregated by currency;
2. Geographic segment information, including segment assets, liabilities, and other disclosure sufficient to assess segment results;
3. Descriptions of subsidiaries or divisions with their locations;
4. Descriptions about business operations, including the economic sensitivity of operations to exchange rate changes; and
5. Discussion of currency hedging policy and transactions, including the rationale for such transactions and their past and expected future financial statement effects.

Currencies of hyperinflationary economies provide special challenges for accounting and can be a contentious subject. Our view is that the accounts of subsidiaries or companies in hyperinflationary economies should be presented at fair value in the local currency and translated at current exchange rates. Indexed financial statements, while simpler to audit, provide less useful data for investment decision making.

## 6. Investors Must Have Clear and Complete Disclosure of All Off-Balance-Sheet Assets, Liabilities, and Other Financial Arrangements and Commitments.

Investors require complete, transparent, consistent, and comparable information about a company’s commitments and other obligations in order to evaluate its risks and future earning power. Similarly, investors need information about the economic resources the company has at its disposal and under its control. We believe that all economic assets and obligations that meet our definitions of accounting assets and liabilities should be recognized in the balance sheet.

Conceptually, all economic assets and liabilities should be properly recognized and measured in the balance sheet. These should include all assets the company owns and all assets in which it holds or expects to receive a beneficial interest. Similarly, they include all liabilities and obligations for which the company bears exposure to risk. All gains, losses, and changes in fair value from these assets and liabilities should be recorded in a single statement that reflects all changes in net assets. We continue to be concerned about managers’ ability to hide assets and obligations by removing them from the financial statements, either at inception or by

<sup>47</sup>This discussion should appear in the Management Discussion and Analysis or similar accompanying disclosure in jurisdictions with this requirement

removing them prematurely. Financial statements that understate assets and liabilities and that fail to recognize company risk exposures severely impair the usefulness of the information provided to investors.

As we have made abundantly clear, we do not believe that economic assets and liabilities should be sequestered and hidden off of the balance sheet. Until recognition and measurement are required, we believe that disclosure must at a minimum include summaries of the types of contracts, commitments, and other financial arrangements in which the company has engaged, along with their economic provisions. The latter would include information similar to the minimum payment disclosures now required for so-called operating leases. We also urge standard setters to require disclosure of estimates of fair value using the same measurement hierarchy as required for other fair value measurements so that investors can adjust the relevant financial statements.

### **6.1 Derecognition: securitizations and special purpose or variable interest entities**

We commend standard setters for their recent efforts to improve consolidation and disclosure for activities and ventures structured solely to achieve off-balance-sheet treatment of company liabilities and risk exposures. We believe that the hurdle for derecognition of existing accounting assets and liabilities must be the complete, unconditional, and irrevocable transfer of rights and obligations to an unrelated third party. That is, we believe that the criterion for derecognition should be a complete severance or termination of the company's involvement with the activity or its assets and liabilities.

Until such changes are made to reporting standards, investors must have the following disclosures for all activities in which a company engages in securitizations or creates a vehicle that results in derecognition under the current standards:<sup>48</sup>

1. Description of any retained interest in securitized or other transferred assets and liabilities disaggregated by type of collateral. The descriptions should include:
  - a. Amount outstanding at the end of the period;
  - b. Average amounts outstanding during the period;
  - c. Portfolio yields, delinquency rates, and changes in rates; and
  - d. Expected maturities for the next five years.
2. Disclosure of assumptions, for example, prepayment, loss, and discount rates, etc., methods used in the calculation of cash flows, values of retained interest, and any recognized gains or losses;
3. Description of the continuing activities of the transferor;
4. Description of the types of risks the transferor retains;
5. Description of the types of guarantees or warranties, actual, permitted, and proscribed;
6. Description of the allowable continuing activities of the transferor, including the extent to which the transferor (or another party) is allowed to retain credit risk, interest rate risk, or any other risks that can be retained through subordinated interests;
7. Definitions of terms and conditions surrounding reissuance of the beneficial interest;
8. Description of the parties that can retain or enter into risks, for example, affiliates, agents, others; and
9. Descriptions of permitted or proscribed derivative instruments.

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<sup>48</sup> Comment Letters by the Financial Accounting Policy Committee to the Financial Accounting Standards Board on *Qualifying Special Purpose Entities and Isolation of Transferred Assets* (31 July 2003) and *Accounting for Transferred Assets* (4 October 1999).

## 6.2 Joint ventures and other equity method investments

It is essential that companies provide clear and complete disclosure of investments in joint ventures<sup>49</sup> separately from the disclosures of other investments accounted for under the equity method. A company's involvement in joint ventures is fundamentally different from its involvement in other equity method investments and this distinction must be made clear.

For each joint venture, substantial and extensive disclosure of the business purposes, the nature of the trade or business, and their activities is essential for effective analysis of the risks and rewards from participation in these arrangements. Ideally, we would like to see disclosure of supplementary financial statements for the ventures, either summary or in complete detail depending upon the significance of the venture to the company. We also need disclosure about the venture's earnings by line of business. In addition, for each venture, the company should disclose any particular contractual or constructive terms, including take-or-pay commitments, guarantees, and contingencies.<sup>50</sup>

## 7. Investors Require Clear and Complete Information about Intangible Assets Held By a Company.

In the global economy, knowledge-based assets and other intellectual property are increasingly the economic drivers for a substantial proportion of productivity. These assets are frequently the major sources of a company's revenue generation or contribute significantly to its expense reduction. Hence, clear and complete information about intangible assets, whether on or off balance sheet and whether purchased or generated internally, is essential for investors' analyses. On 2 March 2001, Robert A. Bayless, chief accountant in the Division of Corporation Finance at the SEC, stated<sup>51</sup>:

*Speaking of value, intangible assets are very important in this economy. Wide variations between a company's stock price and its underlying book value per share frequently are attributed to the failure of the current accounting model to recognize a company's internally generated intangibles. Despite the importance that investors evidently place on those intangibles, a FASB Business Reporting Project Steering Committee observed that filings by public companies generally lacked meaningful and useful disclosures about intangible assets. [Emphasis added]*

Mr. Bayless recommended that managers disclose the nature of the intangible assets that are important to the business and explain what managers do to develop, protect, and exploit them. He also said that managers should provide operating and financial measures to communicate to investors the value of these intangibles to the company. We agree that Mr. Bayless's recommendations are a good start. In addition, however, we recommend that managers disclose the following:

1. Estimates of the fair value of separable and transferable intangibles not recognized in the financial statements or information that would help investors to determine or assess such fair value estimates. The latter disclosure could include nonfinancial indicators, such as market size and share, customer retention, elements of the intangible asset, its characteristics, and value drivers.
2. Disclosure of the principles used for recognition and measurement of intangible assets recorded in the financial statements, especially relating to research and development and other project-related activities.

<sup>49</sup>According to IAS No. 31, *Interests in Joint Ventures*, a joint venture is a contractual arrangement "whereby two or more parties...exercise joint control over an economic activity."

<sup>50</sup>Comment Letter of the Financial Accounting Policy Committee to the Financial Accounting Standards Board, *Special Report: Reporting Interests in Joint Ventures and Similar Arrangements* (27 January 2000).

<sup>51</sup>Remarks by Robert A. Bayless, Chief Accountant, Division of Corporation Finance, U.S. Securities & Exchange Commission, at "The SEC Speaks in 2001", a conference sponsored by The Practising Law Institute, Washington, D.C., 2 March, 2001

3. Disclosure of information about intangibles that are imbedded in other tangible or financial assets, such as core deposit intangibles.
4. Disclosure about the nature of any goodwill recognized and the key variables that would be assessed in impairment tests of the goodwill.<sup>52</sup>

## 8. Investors Require Clear and Complete Information about a Company's Contingencies and Other Risk Exposures.

Traditionally, financial reporting standards have permitted companies to avoid recognition, measurement, and disclosure of arrangements, including executory contracts, commitments, and contingencies, until an unconditionally binding definitive agreement existed. Such a constraint permits managers to structure financial arrangements to avoid recognition or disclosure of material risk exposures until it is beneficial to the company to do so or at settlement or possibly even permanently. Investors bear the ultimate risk for such exposures. Consequently, they should be fully informed of all such contingencies and risks when they arise. We urge standard setters to adopt this threshold.

We also recommend some specific disclosures about these arrangements and contingencies, which should be presented in tabular form:

1. The gross amounts of revenues, expenses, and cash flows arising, or expected to arise, from each arrangement;
2. The nature and total amount of any interests retained, securities issued, and other indebtedness incurred; and
3. The nature and amount of other obligations or liabilities, including contingencies, arising from the arrangements that are or may become material and a description of the triggering events and circumstances that could cause them.<sup>53</sup>

## D. Other Disclosure Issues

### 1. Nonfinancial Disclosures.

Recently, much discussion in practitioner journals and the press has revolved about whether managers should provide nonfinancial information<sup>54</sup> in the financial statements and, if so, what information should be provided. Certainly, nonfinancial information can provide insights into the risk and economic exposures of the company, both good and bad. We are not convinced, however, that the financial statements and disclosures are the proper place for such information. Neither do we believe that accounting standard setters are the appropriate body to mandate such disclosures. Often, the most relevant nonfinancial disclosures are sector or industry specific and may not be auditable in the traditional sense. We believe that only when managers are candid about such nonfinancial influences and factors will investors receive relevant information. In the current disclosure environment, if managers are compelled to comply with a standard for the disclosure of nonstandard information, the tendency will be for the disclosure to quickly devolve into boilerplate rather

<sup>52</sup>Comment Letter of the Financial Accounting Policy Committee to the Financial Accounting Standards Board, *Disclosure of Information about Intangible Assets Recognized in Financial Statements and Reporting Information about the Financial Performance of Business Enterprises* (11 October 2001).

<sup>53</sup>Comment Letter of the Financial Accounting Policy Committee to the U.S. SEC, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations, and Contingent Liabilities and Commitments* (31 December 2002).

<sup>54</sup>In a recent Deloitte survey in cooperation with Economist Intelligence Unit, *In the Dark, What Boards and Executives Don't Know about Their Businesses*, more than 90 percent of respondents (249 executives) said a number of areas of their business whose health cannot be measured in monetary terms are critical or important drivers of success: customer satisfaction, product/service quality, operational performance (i.e., the efficiency and effectiveness of key business processes), employee commitment, and governance and management processes. The clear majority said the same for brand strength (78 percent), innovation (success in developing new products/services; 81 percent), and the quality of relationships with external stakeholders (76 percent).

than to supply the candid, incisive, and informative disclosure that investors need. Therefore, we would prefer that such information be provided in a discussion and analysis section or other unaudited section of the annual report to shareowners.

## 2. Comparability.

Investors do not make decisions about whether or not to invest in a particular company in a vacuum. Rather, the decision involves the weighing of alternative investment opportunities and the selection of the one that best fits the investor's preferred risk and return profile. Therefore, making comparisons is a critical part of the investment decision-making process.

Even companies in the same industry domiciled in the same country make different accounting policy choices, including different assumptions and estimates that can result in widely different financial statements and reported amounts. Among the most obvious reporting issues that currently provide managers with substantial flexibility are leases, revenue and expense recognition, inventories, depreciation, and employee benefit plans. Investors perform their analyses to understand the underlying economics of a company. Given the flexibility, however, the results of the simplest financial analyses, such as the calculation of financial ratios (for example, interest coverage and debt/equity), will not be comparable across companies solely because of the disparity resulting from available reporting options and not the underlying economics. Until such flexibility in reporting is removed, investors will require sufficient disclosure to enable them to reconcile and adjust the reported numbers to a common basis.

## 3. Candor and Honesty: If Not Now, When?

Finally, after the accounting scandals of the past several years, we believe it is time for all companies to emulate Warren Buffett's attitude and his execution when it comes to investor communications. More than 20 years ago, in his 1983 Letter to Shareholders of Berkshire Hathaway, he gave his shareowners the list of business principles that he and his partner, Charlie Munger, believe underpin the manager-owner relationship. Mr. Buffett promised his shareowners that

*[W]e will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candor benefits us as managers: the CEO who misleads others in public may eventually mislead himself in private.<sup>55</sup>*

Managers often claim that they must withhold information because of vague claims of competitive disadvantage. Generally, we are skeptical of such claims because we believe that industry competitors generally know much more about each other than they share with investors. In the interest of full disclosure, however, we do recognize that there are rare circumstances when disclosing information would be detrimental to a company's business strategies. In those rare circumstances, the type of information and the clear rationale for withholding it must be disclosed. Again, companies can take a page from Mr. Buffett's statement:

*Despite our policy of candor, we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore, we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumored to be buying. If we deny those reports but say "no comment" on other occasions, the no-comments become confirmation.<sup>56</sup>*

<sup>55</sup> Warren Buffett, 1983 Letter to the Shareholders of Berkshire Hathaway, 14 March 1984.

<sup>56</sup> Ibid.

Most investors would like to know which investment ideas Mr. Buffett is pursuing at any given time. We expect, however, that many would also understand the merits of his position. Such candid, specific disclosure engenders trust in investors and ultimately market integrity because it is straightforward and permits investors to make their own assessment of the legitimacy of Mr. Buffett's claim. As demonstrated by this and the previous quote, Mr. Buffett's commitment to Berkshire Hathaway shareowners is clear.