UNICE
THE VOICE OF BUSINESS IN EUROPE

POSITION PAPER

18 May 2006

UNICE COMMENTS ON THE REPORT "A COMPREHENSIVE BUSINESS REPORTING MODEL: FINANCIAL REPORTING FOR INVESTORS" BY THE *CFA INSTITUTE FOR FINANCIAL MARKET INTEGRITY*

1. INTRODUCTION

In October 2005 the CFA Centre for Financial Market Integrity produced a report titled "A Comprehensive Business Reporting Model: Financial Reporting for Investors" (McConnell et al. 2005). The report proposes improvements to the current business reporting model that are suggested to enhance the usefulness of financial reporting for investors and investment professionals. In the remainder of this analysis we will refer to the publication as "the Report". As accounting standard setters are continuously looking for improvements to the existing financial reporting model we have to assume that the Report will be used as a basis for changes that will be proposed by international accounting standard setters, notably the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB). It is obvious that accounting standard setters need to pay due attention to the requirements of investors and investment professionals in developing new and changing existing standards. This is anchored in the objectives of the standard setters; e.g. the preface to IFRS states that the objective of the IASB is:

"to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions".

The question that needs to be addressed is whether the Report is a suitable source for accounting standard setting inferences. That this question comes up is due to the fact that many of the recommendations in the Report appear to be at odds with the questions and requests that preparers of financial statements experience in their regular contacts with users of their accounts. In addition preparers are also key users and the Report is also at odds with the way that businesses are managed. Therefore a critical assessment of the Report from the preparers' perspective will be developed in this paper. It is not our objective to resist change or further improvement of financial reporting standards, much more we intend to question a number of recommendations included in the Report and to suggest alternative approaches. Not all recommendations of the Report will be discussed in detail. Those that are most controversial or open to alternative solutions will be focused on. In the end preparers are best served by the application of high quality accounting standards that serve the needs of users. They are the best guarantor for a realistic cost of capital that adequately reflects the risk and return characteristics of business. It is our objective to provide a constructive contribution to the evolution of the future business reporting model in order to ensure a

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realistic cost of capital that is based on well informed investment decisions of financial market participants.

For the time being we will limit our analysis to the usefulness of financial reporting for investment decisions because that is the scope that is also used in the Report. We have to note that this scope is in fact too narrow because it disregards the important fiduciary, internal performance management and governance roles of financial reporting. The importance of accounting from stewardship and contracting perspectives and the contributions from the research into principal agent relationships are not addressed in the Report. These areas require further consideration before a fundamental reform of the business reporting model can be seriously discussed. To remain concise we have decided not to elaborate on these aspects currently and to limit our scope to information for investment decision making in line with the Report.

2. DUE PROCESS AND BACK-UP FOR ASSERTIONS.

The Report appears to be authored by Staff of the CFA Centre for Financial Market Integrity and members of its Comprehensive Business Reporting Model Subcommittee and the Corporate Disclosure Policy Council. The CFA Centre for Financial Market Integrity is a distinct division with its own executive and advisory council that has been established by the CFA Institute. It is impossible to judge from the Report whether it can be regarded as representing views of the full membership of the CFA Institute. It is not explained in the Report whether any due process has been applied in the development of the recommendations for improvement. It is left unclear whether the views expressed are those of the global membership of the CFA Institute (79,000 investment professionals) or those of the 15 named individuals who authored the report. The lack of any observable due process and the general failure in the Report to attribute the recommendations that are presented to input received from a representative subsection of the CFA Institute or investment professionals in general are a serious concern. On the basis of the information provided in the Report, accounting standard setters can only view the recommendations as those of 15 knowledgeable and reputed investment professionals. The Report does not justify that a wider relevance is attributed to the recommendations or that they are deemed to be representative of the views that are held by investment professionals in general. This clearly limits the usefulness of the Report for setting accounting standards.

3. THE NEED TO CHANGE THE REPORTING MODEL.

The Report starts with a quotation from the seminal work of Graham and Dodd on Securities Analysis (1934). At the time the writers deplored lack of information being reported by business. It needs to be noted that financial reporting has developed considerably since that time. The assertion in the Report that “the basic issues of greater recognition and measurement, better disclosure and increased transparency have not changed very much over the last decade” is not convincing in view of the fundamental changes that have been introduced over time. Furthermore, reference is made to financial reporting scandals and bankruptcies in recent years as “underscoring how little progress has been achieved”. The causality between fraudulent behavior of

certain managers and weaknesses in the reporting model is questionable and not explained in the Report.

The Report claims that fundamental reforms of the reporting model are required. However, many of the more detailed proposals that are subsequently presented are already addressed in recent accounting standards (fair value for acquisition cost allocation in business combinations in IFRS 3, SFAS 141, expensing share-based payments in IFRS 2, SFAS 123R). Therefore the claim that opportunities for significant improvements exist is not actually backed-up by many concrete proposals. Having said that, it is also important to comment on some of the specific principles formulated in the Report.

4. FAIR VALUE INFORMATION IS THE ONLY INFORMATION RELEVANT FOR FINANCIAL DECISION MAKING.

The Report criticizes the current mixed model that combines fair value measurement with historic cost measurement. It proposes that fair value measurement should be applied to all assets and liabilities. The argument that is presented to support this proposal was already presented in the 1993 report of the predecessor of the Centre for Financial Market Integrity and reads as follows:

"*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…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."*

These statements are no doubt correct; the question that is not addressed in the Report is whether they are relevant. At the micro level of individual assets or liabilities fair value information might be relevant but the objective of financial reporting is to inform market participants about the size, timing and uncertainties of future cash flows of the company and its business segments.

Only in a world of perfect and complete markets can the fair value be precisely defined (Beaver, 1998). In such a world accounting would be obsolete (Beaver/Demski, 1979). However, real world markets are in most cases neither perfect nor complete and consequently generate more than one fair value for the individual asset (Ballwieser, 2004).

The Report offers neither theoretical arguments nor empirical support that would justify the implicitly assumed relevance of fair values of individual assets for the value of companies. It is well known that the value of an entity cannot be readily derived from the summation of individual assets and liabilities. As we understand it, analysts use estimates of future (free) cash flows from continuing business as a basis for their valuation of companies. These cash flows are projected on the basis of analyses of historic and actual cash flows of companies and/or individual business segments. This approach is also applied internally by companies for the evaluation of investment and acquisition opportunities. In case fair values are deemed to represent predictors of

future cash flows then they need to incorporate management intent which is obviously not the case with hypothetical exit values.

One objection against an increased use of fair value measurement is that it can create misleading volatility in financial statements. Volatility that does not reflect underlying economic volatility provides no benefit and it is well known that earnings volatility can create costs related to the use of accounting information in contracting, including regulation (American Accounting Association response to the G4+1 Special Report "Reporting Financial Performance", 2000), therefore such volatility has to be avoided. We furthermore object to the increased use of fair value measurement because evidence that fair value information actually allows better investment decisions and more accurate forecasts of future cash flows is lacking. Accounting standard setters are called upon to investigate other directions for further improvements of their standards taking into account that:

1. There is a considerable body of academic research that suggests that traditional accrual based income is a good predictor of future share prices. Furthermore the additional information content of components of other comprehensive income has been found to be limited (see Biddle and Choi 2003).

2. Investment analysts are known to use net income figures in developing cash flow estimates. This is clear from their published analyses of company performance and also acknowledged in private conversations and public statements.

3. Many companies across the globe have introduced value based management techniques in the last three decades to ensure that their decisions lead to the creation of additional value for their shareholders. These techniques are usually based on predictions of future free cash flows at the level of businesses or cash generating units. Many companies also started to disclose information on their value based management programs and to present value based performance measures to their investors, both in annual reports and in investor relations presentations. It would be more worthwhile to investigate the merits of such information for investors than to increase the requirements to disclose fair value information.

4. Return on invested capital remains an important performance measure that is widely used both inside companies and in communication with investors. Increased use of fair value measures will make such measures less informative because they become distorted by fair value changes that are unrelated to the performance of management and the success of managers in productively utilizing the assets that have been entrusted to them.

5. RECOGNITION AND DISCLOSURE MUST BE BASED ON RELEVANCE AND NOT ON MEASUREMENT RELIABILITY ALONE.

That investors need to receive all information relevant for decision making is not disputed. We are concerned by the assertion that reliability is an attribute of relevant information and that all information should be disclosed whatever the level of reliability may be. In this respect it is important to recall that the purpose of financial reporting is to provide information that is useful for business decisions (Concept Statement No. 1, FASB, 1978). From a practical point of view we can comment that information that is lacking in reliability is not useful for business decisions and is not used by business managers for that reason. More worrying is the suggestion to disclose such information because to do so is likely to reduce the credibility of financial reporting. If the goal of financial reporting is to reduce information asymmetries between insiders and outsiders of the company, credibility of financial reporting is a key issue (Ballwieser, 2004). To put it simply: If the users do not believe the accounts they would refrain from using them as a basis for their investment decision. Accounting standard setters would first of all do themselves a big disservice in following up this recommendation of the Report because it may be seen as decreasing the usefulness of financial reporting in the eyes of public policy makers and many users of financial statements. What policy makers require is best illustrated by the recent call for a public hearing of the US House Committee of Financial Services that calls for information about public companies to **be understandable, accessible, and accurate**".

We question whether financial information based on what has actually taken place is not of more use to analysts as a basis for forecasting future cash flows of companies than information on what might have if assets had been disposed of in a fictitious transaction which a company may not even consider undertaking.

6. FINANCIAL REPORTING MUST BE NEUTRAL.

The Report starts the call for neutrality with a reference to the fact that an accounting treatment must be based solely on what method best captures the economic substance of an item. From this starting-point it claims that existing choices between accounting options in standards have led to earnings manipulation and abuse and therefore these choices have to be eliminated. The logic of this reasoning is questionable. First of all manipulation and abuse are present when accounting methods are applied that are not in accordance with existing standards. That accounting fraud occurs is not denied, however in many cases that is done by knowingly deviating from existing standards, not by applying options that are available in the standards. Financial reporting is subject to differences in firm-level economic circumstances and business models. Choices in accounting standards provide the opportunity to ensure that the chosen method best captures the economic substance of the transaction and can therefore ensure representational faithfulness.

It is further argued in the Report that:

"strict fair value reporting demands that managers determine the unbiased expected value by forecasting the possible outcomes and applying probabilities of the outcomes".

Such a claim is a contradiction in itself. Forecasting future outcomes is not only difficult, it is impossible to do this without using managements' view of what the future may be. Such a view can simply be wrong and will certainly differ from the view of other managers at the same moment in time. Unless liquid and transparent market prices for homogeneous objects exist, like for some financial instruments and commodities, it is difficult to understand how neutrality and comparability of financial reporting would benefit from an increased use of fair value measurement.

7. ALL CHANGES OF NET ASSETS MUST BE REPORTED IN A SINGLE FINANCIAL STATEMENT.

It is well known that the Center for Financial Market Integrity and its predecessor organization request a single performance statement that includes all changes in net assets that are not related to transactions between the company and its shareholders. The motivation for this request is:

"As long as a single summary 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. Therefore we are proposing a financial reporting model that does not focus on a single earnings number".

It is first of all important to note that the Report does not require a single statement because it enhances the ability of users to estimate the value of the company. We already presented arguments in section 4 that show that information that is relevant for the determination of the value of the company would actually be lost if net income was no longer reported. Secondly, there is a fundamental flaw in the reasoning that is provided. To avoid manipulation of earnings numbers effective oversight by market regulators and auditors is required. They provide the safeguards against manipulation together with high ethical and business standards of managers that are responsible for financial reporting. If these safeguards are not sufficient they need to be strengthened. The desire to create accounting standards that avoid manipulation will inevitably lead to more rule-based standards that make financial statements more detailed and opaque without addressing the root cause of the problem.

The Report states that all changes in net assets should be reported clearly and understandably in a single statement. However, it is difficult to see how such a statement, especially when combined with more use of fair values, will make financial statements more clear and understandable for users.

Before rushing to a single performance statement, accounting standard setters might wish to consider the following statement from one of the leading textbooks on financial statement analysis:

"*once forecasted (reformulated) income statements and balance sheets are prepared, forecasting free cash flow involves one simple calculation from these statements. It is hard to think of forecasting free cash flow without thinking of future sales, profitability and investments that will be reported in the income statement and balance sheet so forecasting these statements is needed to forecast free cash flow*." *(Stephen H. Penman, Financial Statement Analysis & Security Valuation, 2001, p. 324).*

The quote illustrates that accrual based income statements are well tested by the capital markets and are well understood, analysts have developed the competence of deriving relevant information from them.

8. THE CASH FLOW STATEMENT …SHOULD BE PREPARED USING THE DIRECT METHOD.

The Report requires the presentation of the cash flow according to the direct method because the indirect method is purported not to provide the disaggregation of cash flow data that is required for forecasting future cash flows. It is commonly known that direct method cash flows are only reported by a very small minority of companies although they are permitted by both IFRS and US GAAP. Companies prefer to report indirect method cash flows because that is the information that they use internally, both for estimating future cash flows, and for performance measurement and incentive purposes. The information from indirect method cash flows is adequate for these purposes and managers have found no need to revert to direct method cash flows that would be much more expensive to measure and highly erratic. The assertion that direct method cash flows, which are unreliable and subject to measurement error because they are not embedded in accounting systems and customary internal controls , are more useful to forecast future long-term cash flows is difficult to understand. The link of the indirect method cash flow to the income statement and balance sheet has proven to be a great help in ensuring reliability and quality of forecasts which managers would not want to lose. The preference expressed in the Report is also at odds with the views of analysts who participated in the IASB International Working Group on Performance Reporting where, as we have learned, the consensus was that indirect method cash flows are at least as useful as their direct method counterparts. Indirect method cash flows are preferred by companies because they have proven to be a useful tool of management and because they can be obtained at a reasonable cost. It should also be recognized by those that advocate the direct method that the cost for system changes and additional accounting work required to obtain the required information is very significant and will ultimately have to be born by shareholders.

9. AN ALTERNATIVE WAY FORWARD.

The analysis we have so far presented demonstrates that alternative views can be developed with respect to possible improvements in financial reports. That fundamental changes to reporting conventions are required is not confirmed by the requests that companies receive in their regular contacts with investment analysts. The analysts ask for more information about markets and competitive positions, performance of business segments, innovation, prospects for new products and services, and the strategic options open to the company. Improvement areas for financial reporting certainly

emerge from these contacts. It is for instance undisputed that current pension accounting contains pragmatic solutions that are difficult to reconcile with accounting theory. Therefore improvement areas exist but they appear to be far more limited than requiring fundamental changes to the accounting model. Accounting standard setters are requested to investigate the information that is provided to investment analysts in addition to financial statements during analyst meetings and briefing sessions to obtain a better insight into required changes in accounting standards that can enhance the decision usefulness of financial reporting. Placing undue reliance on the recommendations of the Report would not be their best option.

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