ARE CORPORATE ACCOUNTING SYSTEMS OUT-OF-DATE?

We can all agree that today's business environment is complex, especially thanks to technological advances, and that traditional ways of doing business are, in fact, becoming quite short-term in many instances. Today's hard goods manufacturer may well be tomorrow's leading services provider in one sector or another. (The disappearance of the ATT Bell system's long-term manufacturing dominance is one example in telecommunications.) As industry changes, intriguing questions arise: Are our 500-year-old business accounting systems, mostly based on hard goods transactions, becoming obsolete? Are our current methods of corporate financial reporting—as complex and comprehensive as they are — increasingly out of touch with the real needs of 21st-century investors and shareowners? Are investors being ill-served and perhaps even misled by their reliance on today's dual pillars of the capital markets: corporate accounting and financial reporting?

Some market players seem to think so, judging from presentations and comments at a June 2005 conference on "The Future of Corporate Reporting" in New York City. Participants included representatives of regulatory bodies, research analysts, money managers, corporate financial executives, corporate investor relations officers, and academics. There were many suggestions offered for improving traditional accounting systems and enhancing corporate disclosure (and financial reporting).

The conference was presented by the Robert Zicklin Center on Corporate Integrity, Baruch College, City University of New York, and cosponsored by the CFA Institute's Centre for Financial Market Integrity and the National Investor Relations Institute (NIRI). CFA and NIRI stated that the reasons for offering the symposium included the need to explore new regulatory initiatives that place a high priority on the importance of accurate and transparent corporate reporting, which in turn are important to restoring investor confidence, driving value, and emphasizing long-term investment potential.

Speaking for the CFA Institute, Dr. Rebecca McEnally, Director of its Capital Markets Policy Group, said the most important issue facing the markets today is financial reporting. CFA's 78,000 members, including analysts and money managers, rely on accurate reports from public issuers, and improvements are needed in today's accounting, reporting, and disclosure systems, she stated.

Baruch Lev offers challenging concepts

Professor Baruch Lev of New York University offered his opinion that in "530 years of accounting, not much has really changed" and suggested that dramatic new approaches are needed. His key points:

- Almost all items in the cash statement or balance sheet are really based on management's estimates, not necessarily on well-established facts; as a result, these items can be volatile and unpredictable.
- Reported "earnings" of companies are often (also) best estimates, as in the example of a large-cap issuer that "finds" one penny additional in a

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IN A GIVEN COMPANY, AS MUCH AS 25 PERCENT OF $100 MILLION IN REVENUES MAY BE ESTIMATED.

quarterly reporting period. ("Absurd," said the accounting professor. "This is a case of massaging the numbers.")

- In some complex companies, revenue recognition can only be estimated, given the variables and factors involved in determining actual revenues in a given time period. In a given company, as much as 25 percent of $100 million in revenues may be estimated. But these revenues are then publicly reported by management as "facts."
- More facts of different kinds need to be publicly reported, such as management's explanation of its basis for creating revenue or earnings estimates (e.g., key rates, times, durations, and other important formulas known only to the senior management of the issuer).
- While GAAP is an important framework today, it needs to be improved by all users, for it is clearly inadequate.
- As the nature of national and global economies has changed, the importance of non-financial measurements—"intangibles"—has significantly increased, but our methods of accounting for these factors have lagged.

"In some cases," Professor Lev declared, "as much of two-thirds or three-fourths of the real value of the company is based on intangibles, and investors are not getting the information they need to make decisions. We need issuers to supply more facts and let others decide the real value of shares."

Professor Lev, who holds the Philip Bardes Professor of Accounting and Finance Chair at NYU's Stern School of Business, offered this example: The research and development (R&D) pipeline of a major pharmaceutical marketer is an important determinant of future value. Today, as R&D is expensed, the real value of a potential drug, including a "market blockbuster," is not transparent to investors. "We know that if a drug is approved by regulators at the end of Phase I trials, it has a 25 percent chance of making it to market. We know that by the end of Phase III trials, those odds move to 75 percent favorable. This movement [through the R&D pipeline] has a direct impact on top and bottom lines. Nowhere in the present accounting information do we find guidance on these important drivers of values."

Another example he offered is the quality and extent of training within a firm. "There is a cause-effect, input-output linkage with training and turnover. Is a firm doing more or less training? Is there a direct link to employee turnover?" In truth, said the professor, "most executives really don't know the costs of training, or the real value of alliances (and the average large company has 30 or more), or the asset value of the firm's intellectual property, or the contribution of these and other factors to either cost savings or earnings." Today's accounting systems, he noted, do not reflect any of these important factors. "Facts are facts," he told the conference attendees, and methods are needed to better report facts to investors. Professor Lev's current research involves determining "how" estimates are being done by management.

Michael Starr, director of global risk management, Grant Thornton International, suggested that public corporations start presenting more factual information and let others (users) come to their own conclusions. Current reporting models do not allow this approach, he observed, and the rules are too complex. What kind of "better information" could be disclosed? Accountant Starr suggested that management better explain:

- The corporate business plans;
- Strategies (and the result of their execution);
- Risks facing the enterprise; and
- Opportunities.

And yes, he cautioned, increased disclosure on these topics could lead to increased legal liabilities—that is why litigation reforms are needed, along with improvements in disclosure practices.

FASB moving forward with projects

Suzanne Bielstein, representing the Financial Accounting Standards Board (FASB), reminded attendees that FASB began foundational work in spring 2004, addressing "the conceptual framework of financial statements and their utility," which is a "relook" at current accounting and reporting practices. These projects could lead to new standards for displaying certain information on financial reports. "Fair value" estimates and measurements of assets is one example of a project in progress; another FASB study effort involves the methods of separating facts from estimates. (Ms. Bielstein is director of major projects and technical affairs for FASB, managing R&D activities related to new accounting standards.)

CFA: Separate facts from guesses; more articulation

In response, CFA Institute's Rebecca McEnally said that investors and analysts need the best information "into the future," vs. basing decisions on "old sales information" contained in certain financial reports, which tend to be historical. "We need extra dimensions to be added to numbers reported by those who run the business," she suggested. "We need to separate facts from guesses. As we have heard, even the cash balance sheet may be a guess." What is needed, in her view, is an articulation of how things flow through financial statements, which trace their beginning from the trading systems of Italy five centuries ago, when investors and partners needed to track gains and losses over the relatively short (three to five years) lives of ventures. "Accounting must reflect the realities of today's business environment and the global economy," she noted, and perhaps it is time to reevaluate traditional accounting methodology.

Panelist James Ryan, corporate vice president—investor relations for the giant defense firm Lockheed Martin, cautioned that there could be legal exposure for managers straying too much from the accepted norms of accounting and financial reporting. "There is an opportunity for management to address factors and explain strategies in the MD&A,"he advised, "where information about business drivers, key market factors, the fundamentals for estimates could be discussed."

Could XBRL be an answer?

Michael Willis, partner in the accounting firm PricewaterhouseCoopers, described the work of 350 organizations in 24 countries working cooperatively through the non-profit XBRL International organization to evolve useful and more uniform formats for business reporting. "We have moved from papyrus to paper and now to computer systems," he said, "and extensible Business Reporting Language (XBRL) is becoming an important means of putting data and the numbers in a uniform electronic format that can be modeled extensively." Financial analysts, for example, could pull uniform financial data from XBRL and still be able to use their many varieties of modeling for developing their own unique forecasts. Preparers can identify relationships of numbers and factors in transactions by using XBRL, greatly increasing its utility. "XBRL creates the public means of collaboration by all market partners." However, Mr. Willis noted that there is still much information that companies do not want to disclose to competitors, presenting a challenge to the expanding use of XBRL.

"There is not much agreement on single methods of presentations," FASB's Suzanne Bielstein responded, "and it would be great to have the ability to tag information and, with the push of a button, consolidate and un-consolidate information. But this is going to be a huge challenge to achieve."

The IR officer and the analyst

Cosponsor NIRI's CEO Louis Thompson said that many members of his organization—investor relations (IR) officers representing several thousand U.S. and foreign companies—work diligently to get both buy-side and sell-side analysts to "move the needle" on important non-financial valuation factors, but many analysts are not interested. "IR officers try to get analysts to get new perspectives, look at new views, and to examine such factors as quality of management, corporate strategy, and the ability to articulate and deliver on strategies, which can be more important than simply looking at earnings." Results are often disappointing, he said.

His NIRI board colleague, Lockheed Martin's James Ryan, said that while it is true that many metrics other than "the numbers" are important in determining value, the news media do not understand such data, nor are they interested in the "nonfinancials." Referring to the suggestion that

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GENERAL ELECTRIC, THE LARGEST U.S. COMPANY IN TERMS OF MARKET CAPITALIZATION, DISCLOSED THAT ITS EARNINGS FOR THE YEARS 2001 THROUGH 2004 AND THE FIRST QUARTER OF 2005 WOULD HAVE TO BE RESTATED.

non-GAAP, but still material, information be disclosed—such as same-store sales or drugs in the pipeline—his view was that there should either be very broad disclosure to all users or no use of non-GAAP data at all in discussions. And inside the firm, many lawyers will "just say no" when managers "go beyond the numbers." We are told, *"If you don't have to, don't!"* explained Mr. Ryan.

A current example: GE restatement

In May 2005, just prior to the conference, General Electric, the largest U.S. company in terms of market capitalization, disclosed that its earnings for the years 2001 through 2004 and the first quarter of 2005 would have to be restated. This action was commented on by some panelists as an example of the types of issues arising in current accounting and financial reporting as transactions become more complex.

The primary reason for GE's action, reported the *Wall Street Journal*, was that accounting for derivative deals was "misapplied," though the restatement had minimal effect on GE's yearly profits. **"Still,"** reported the publication, "the revised figures show the company's earnings would have been volatile in some of the quarters and that GE would have missed analysts' estimates had the hedges been accounted for properly." So just how important was the GE misstep? There was no apparent consensus at the financial reporting symposium. Investors will have to judge for themselves.

Commenting on GE's dilemma on Forbes.com, Elizabeth MacDonald wrote: "So finally General Electric admits it has been tripped up. Market watchers and media pundits bruited about their suspicions that [GE's] abstruse bookkeeping harbored some kind of accounting time bomb. On Wall Street, GE's name became synonymous with earnings management. How else could a company pull off a miraculous feat, where, quarter after quarter, year after year ... it met or beat estimates by a penny or more?"

Then, on a more realistic note, Ms. MacDonald pointed out that "critics are in for a letdown. In the grand scheme of things, GE's [restatement] problems are picayune and can be blamed on mind-numbingly complex accounting rules for derivatives ... The restatement [will] result in a non-cash increase to earnings ... of $381 million . . . GE's shares are holding steady at $36." *Mind-numbingly complex is* a term that apparently would resonate with some panel members who were calling for reform of the accounting system—or development of a substitute that would deliver more information to the markets.

Quality of accounting and disclosure

Arthur Levitt, former Chairman of the Securities and Exchange Commission, observed in 1997 (as the bull market neared its peak): "I firmly believe that the success of capital markets is directly dependent on the quality of the accounting and disclosure system. Disclosure systems that are founded on high-quality standards give investors confidence in the credibility of financial reporting— and without investor confidence, markets cannot thrive." Chairman Levitt also described "good" accounting standards as those that "produce financial statements that report events in the period in which they occur, not before, and not after."

Accounting professor S.P. Kothari, from the Sloan School of Management at Massachusetts Institute of Technology, in a June 2000 paper prepared for a Federal Reserve Bank of Boston conference, noted that: "Market participants seek high-quality financial information because it mitigates information asymmetry between the management of the firm and outside investors. Reduced information asymmetry has desirable effects on the cost of capital and volatility of [security] prices. Regulators around the world strive for high-quality accounting systems. The quality of reported financial information is influenced [however] not just by the quality of accounting standards but by other institutional factors that affect the demand [for] and supply [of] financial information." He cited as "institutional factors" the nature of corporate governance, the legal system, and the existence and enforcement of laws governing investor protection and disclosure standards.

How do we apply realities to conceptual frameworks?

In a parallel to the discussion of "real-world" factors and "theoretical frameworks" such as global accounting systems, Harvard professor and well-known economist John Kenneth Gailbraith wrestled with the totality of the impact of the corporation on American society and our knowledge of economics in a 1994 essay "Victory From Defeat," which focused on the rise of the German and Japanese economies after World War Two. He compared the corporate management systems of the two former enemies of the United States with the late-1980s-early-1990s style of U.S. management. His conclusion: No other motivating economic force in the United States is as powerful today as the maximization of profits, for both corporate management and shareowners. It is the key to corporate success. (And all the important capital market players want "profits" to accrue to *their own* benefit.)

Yet, he wrote, "this reality has little standing in formal economic doctrine. That which is not easily accommodated to the approved field of economics is systematically and simply *ignored."* The development of the U.S. service economy, of an increasingly intellectual property-based system of wealth, is still not given the recognition (by economists) of the "smoking chimney, producing goods for the masses." Professor Galbraith believed that the base of the economy "has to do with real production, real work. Economics strongly, perhaps even proudly, affirms its own obsolescence." In some ways, this thesis could apply to some of the basic principles of accounting and financial reporting, which are not keeping pace with the shift to a service- and information-based economy.

Governance, enforcement, and accounting information

Professor Kothari may have provided important guidance for all parties involved in improving our present accounting systems, corporate disclosure practices, and financial reporting: "Investor protection laws, corporate governance structures, and the quality of law enforcement jointly influence the demand for accounting information. These factors and mandated standards determine properties of reported financial information. Standard-setting decisions should take [these institutional factors] into consideration, rather than be taken in isolation. A simultaneous push for greater shareholder protection and transparent accounting standards is warranted."

Sarbanes-Oxley: Three years and counting

And so, after failures in the very institutional factors cited, with numerous corporate accounting scandals and financial reporting frauds splashed across media headlines for months at a time, July 2002 brought the passage of the comprehensive Sarbanes-Oxley (SOX) package of legislation that updated many provisions of the 1930s securities laws and introduced new concepts in corporate governance, financial reporting, and disclosure.

SOX passage was followed by extensive rule-making by the Securities and Exchange Commission; upgrading of New York Stock Exchange- and NASDAQ Exchange-listed company codes; creation of the Public Company Accounting Oversight Board (PCAOB), to address audit standards and quality; continued implementation of Regulation FD (enacted prior to SOX); criminal prosecutions of executives charged with fraud; and the long, laborious, and expensive process of implementing SOX Section 404 provisions for revenue recognition.

All of these changes derive from issues related to accounting, financial reporting, disclosure practices, management disclosures, and failures in governance. Each issue is being addressed in serious ways by capital market players, including regulators, investors, and corporations.

It was clear from opinions stated at the Future of Corporate Reporting conference at Baruch College that key players believe "more" is needed in terms of accounting standards and financial reporting practices. As NYU accounting Professor Baruch Lev stated, "investors love predictable results. Analysts need

BOTTOM LINE: IT IS REALLY ALL ABOUT CONFIDENCE—INVESTOR CONFIDENCE.

the numbers to give to investors. More disclosure of facts would help us to understand the numbers and results, which would create more confidence in the disclosures." Bottom line: It is really all about confidence — investor confidence. That, just about everyone can agree, is the most valuable commodity in the market today! •

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