# Ross Roundtable Discussion

## Low-Cost Improvement in Financial Reporting

## November 11, 2003

Low-Cost Improvements in Financial Reporting, the topic of the recent Roundtable, was designed to explore the relatively simple changes that regulators and the accounting profession could implement to enhance the utility of financial reports. However, the discussion quickly developed into a springboard to bold and innovative "out of the box" thinking; wherein the four corners of the "box" are the income statement, balance sheet, statement of cash flows and retained earnings. The new ideas discussed can perhaps be viewed as a "Back to the Future" course of action. The challenge presented by one of the participants, and quickly picked up by others, was a "let's get back to the basics" idea. Capital, labor, production, and other non-exotic variables. The 1902(!) financial reports of US Steel were set forth as an example of the usefulness of disclosing information relating to the firm's production function.

The discussion revolved around the users of financial information. As a member of the SEC remarked, the needs of users differ from what preparers want to disclose. Preparers are looking for clear-cut rules to follow, primarily to guard against litigation. Users, a group that has to date been relatively undemanding of the SEC, would much prefer decision usefulness, mostly in the form of items that will facilitate the prediction of future earnings.

**The Basics:** Albeit that manufacturing data and the production function have not been the "stuff" of which headlines have been made, the elements of Cost of Goods Manufactured and Cost of Goods Sold are nonetheless far from extinct or diminished in relevance. In the opinion of some of the participants, we are consumed with debates on complex issues such as which option-pricing model is more reliable in estimating stock-based compensation, but we neglect to disclose the simple factors of production. Anyone trying to project financial statements starting with revenues and cost of goods sold don't have a chance at success. Examples of items and details useful to analysts are:

**Depreciation**: Depreciation expense (and related accounts) should be reported for each class, nature, and function. A clear presentation of depreciation expense incorporated into cost of goods sold, SG & A, and other categories should be disclosed.

**Compensation Expense**: The cost of production labor, expenses related to sales, administration, and management, with/without stock-based compensation should be classified and disclosed separately.

**Revenue Recognition Policies:** Required disclosure and a mapping of the policy employed for main classes of revenues.

**MD&A:** The Roundtable discussion was then broadened to effective communication of measures that are outside the financial reports, which can be accomplished through the MD&A. There are numerous metrics used by retailers, the hotel industry, the media sector, etc., that are useful for comparing performance and that could be disclosed in the MD&A. A special section on "sensitivity analysis" was proposed. The SEC is currently considering an interpretive release suggesting a "summary MD&A", urging management to discuss issues that are on the front burner.

Not all participants were in agreement about the usefulness (or lack thereof) of GAAP-based financial reports. It was noted that disclosures made by pharmaceuticals and banks provided specific information useful for projecting future performance, such as the product pipeline. The issue of the costs of disaggregation and allocation efforts which may exceed the benefits was raised. Limited corporate resources may be better spent by expanding the business rather than on preparing reports that improve analyst's ability to predict earnings.

Food for thought was provided in comments pertaining to continuous efforts to place the burden on the accounting profession of creating a set of constructs broad enough to cover disparate issues and industries. GAAP can create basic constructs, but cannot close the gap between the reports and the valuation and analysis process that remains outside of the standard setters mandate. There will remain an area of discontent in an environment where real-time information is in demand.

**To the Future:** Rather than present a *laundry list* of suggested changes, the question should be what do users want? Do they want to predict earnings? Cash flows? Growth? Are they interested in understanding enterprise performance? How does the individual user define performance? The FASB's Financial Performance Reporting Project is attempting to answer some of these questions, but needs a "conceptual framework" to consider the various laundry lists of items proposed by respondents.

The purpose of the 1970's Conceptual Framework was to establish the objectives and concepts that the Board will use in developing standards. The Board acknowledged the limitations of the information provided by the accounting model, but anticipated that knowledge of the objectives and concepts would lead to improved understanding and decision usefulness. Unfortunately, the standards are not always consistent with the framework. The inconsistencies in promulgated statements are often the results of time-sensitive political pressures. Recognizing these flaws, and accepting that imperfections will continue to exist, perhaps it is time to start asking new questions for a new economy. How relevant are the current income statement, balance sheet, and cash flows statements in today's environment? Is it time to move on and incorporate new forms of corporate reporting?

A particularly intriguing suggestion made during the discussion was to use the output generated from the GAAP based accounting model and additional information to inform about the sensitivity of a firm's cash flows and earnings to prospective economic changes, such as interest rate, foreign exchange or oil price changes. Internally generated accounting information can be combined with external economic variables through the use of time-tested rigorous econometric models. Thus the *critical value drivers*, variables that are exogenous to the accounting model, can be the bridge to get us "out of the box" and into the future. We have already taken baby steps in this direction by employing option-pricing models for ESO's.

Participants were split as to the choice of model that should be prescribed by the FASB, and if the process should be subject to audit. The difficulty of finding a common denominator, a set of models suitable across industries was recognized, and the comparability of results, even within industries, appears problematic. There was however a consensus of opinion that the time has come for the accounting profession to join the technological revolution. The risk of litigation has always been a major factor in the unwillingness of managers and auditors to include forward-looking information in their financial reports, and should be reconsidered.

The Roundtable exploration of simple changes that would enhance the transparency and utility of financial reports produced a back to basics and on to the future set of recommendations. Disclosure of the factors of production and disaggregation of the elements of financial reports was a key issue. Although participants used the term "disaggregation", one must consider if this is not a call for de-consolidation. Perhaps the desired level of disaggregation could be achieved if in addition to consolidated statements, companies were required to present individual financial statements, rather than just financial highlights, for the primary majority owned subsidiaries.