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COMMENTARY

Peter H. Knutson and Gabrielle U. Napolitano

Peter H. Knutson is an Associate Professor Emeritus with the University of Pennsylvania and Gabrielle U. Napolitano is a Vice President with Goldman, Sachs & Co. and is the Financial Accounting Policy Committee Chair.

Criteria Employed by the AIMR Financial Accounting Policy Committee in Evaluating Financial Accounting Standards

OVERALL CONSIDERATIONS

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR) does not have its own conceptual framework. However, AIMR's 1993 Position Paper, *Financial Reporting in the 1990s and Beyond*, guides the Committee in its preparation of written commentary on initiatives by regulators and standards setters, such as the Financial Accounting Standards Board (FASB), the International Accounting Standards Committee (IASC), the United States Securities and Exchange Commission (SEC), and others. *Financial Reporting in the 1990s and Beyond* sets forth and explains the rationale underlying the bases of the FAPC's conclusions and its ultimate recommendations of specific models for corporate accounting practice and disclosure. Certain broad themes also prevail in its internal discussions and comment letters.

This is an excerpt from a longer report of the Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR), prepared for the 1997 AAA/FASB Financial Reporting Issues Conference. AIMR is a global not-for-profit membership organization with more than 80,000 members and candidates comprised of investment analysts, portfolio managers and other investment decision makers employed by investment management firms, banks, broker-dealers, investment company complexes and insurance companies. The Association's mission is to serve investors through its membership by providing global leadership in education on investment knowledge, sustaining high standards of professional conduct, and administering the Chartered Financial Analyst (CFA®) designation program. The Financial Accounting Policy Committee is a standing committee of AIMR charged with maintaining liaison with and responding to initiatives of bodies which set financial accounting standards and regulate financial statement disclosures. The FAPC also maintains contact with professional, academic and other organizations interested in financial reporting.

"Bright Lines" vs. "Economic Substance"

The FAPC usually eschews so-called "bright lines." Such clear delineations invite gaming of the accounting standard. One does not have to read the investments section of many financial reports to discover how many 19.9 percent and 20.1 percent equity security ownerships exist. Even though there is no difference in substance between these ownership interests, the accounting differences are immense. The FAPC generally prefers to have an accounting standard address matters in terms of their economic substance.

A Single Measurement and Recognition Standard

Standard setters should mandate a single standard for recognition and measurement in the reporting model. A single standard enhances comparability and improves the reliability and relevance of the financial information presented to users. Lack of a specific measurement basis and presentation format compromises the usefulness of the information to the investment analysis and decision-making process.

It is the need for that single recognition and measurement standard that underlies the FAPC's and the AIMR's strong support for the efforts of the IASC and, to a lesser extent, the "G4 + 1."[1] The FAPC looks forward to the day when there are no longer significant differences among the accounting principles used throughout the world. The FAPC also believes there is no reason to have different principles of measurement and recognition for enterprises of different size, so-called "Big-GAAP and Little-GAAP," although some differences in disclosure may be warranted for privately-owned enterprises. Finally, the same principles ought to apply to not-for-profit as well as profit-seeking entities. In many—but not all—cases, the measurement and recognition standards used in the private sector should also apply to governmental entities.

SUMMARY OF SPECIFIC CRITERIA

Those criteria the FAPC considers most critical to the promulgation of high-quality financial accounting standards are listed below. In the following section, each is discussed in turn.

1) A new standard should improve the information that is available to investment decision makers.
2) The information that results from applying a new standard should be relevant to the investment evaluation process.
3) Certain financial information is better presented outside the audited financial statements, and should not be included in the scope of a financial accounting standard.
4) The information that results from applying a new standard should fit the double-entry accounting model, or should enhance understanding of the data contained in the model.
5) Economic phenomena that are similar or equivalent should be depicted as such in financial statements. That depiction ought to conform to underlying economic reality.
6) Current values usually are more useful than historic amounts, subject to reliability of their measurement.

[1] The "G4+1" consists of the standard-setting bodies of the United States, Canada, Australia and the United Kingdom, plus the International Accounting Standards Committee.

7) Extensive disclosures usually must be required as an integral part of a new accounting standard. They are necessary: (1) to overcome the deficiencies of the mixed-attribute accounting model; and (2) to help users understand the effects and implications of management's accounting choices. Disclosures are not, however, a substitute for measurement and recognition.
8) "Smoothing" and "normalization" is a function of analysis, not financial reporting.

CRITERIA FOR HIGH QUALITY STANDARDS DISCUSSED

1) *A new standard should improve the information that is available to investment decision makers.*

Beyond all else, financial analysis and investment evaluation demands information. AIMR members often are accused of wanting to know everything. In reality, that is less of an onus than it is a compliment. Analysts are "information junkies." However, assertions to the contrary notwithstanding, analysts are not unreasonable in their requests. (See points 2 and 3 below.) They realize that sometimes it is costly to produce new information and, therefore, the benefits should exceed its cost. At the same time, they have observed in the case of Statement of Financial Accounting Standards No. 106, for example, that the cost of producing new information may be exceeded by the twin benefits of better-informed management actions and better-informed capital markets.

The most useful and important accounting standards are those that provide new information that could not previously have been estimated by outsiders. That, for instance, is why a standard that establishes rigorous criteria for reporting segment financial information ranks first in importance with analysts, in general, and the AIMR and its Financial Accounting Policy Committee, in particular. Such a standard results in financial market makers receiving information that simply could not be obtained otherwise.

A corollary to this criterion is that details are important. Disaggregation and decomposition of aggregate and summary data provide analysts and other investment professionals with extremely important data. Averages, aggregates and offsets can be misleading. It is the highs and lows, the blemishes and sore spots, that reveal the precise nature of the risks and rewards embedded in a particular investment opportunity.

On the other hand, the FAPC was not at the forefront of those asking the Board to set standards of measurement and recognition of the cost of compensation from the use of options on an enterprise's own stock. There were several reasons. The one that applies here is that a new standard would not have created significant new information. Much of what the FASB's proposal sought to do was to report information already available in other formats, such as the SEC's required disclosures in proxy statements. The majority of the FAPC supported the FASB's stock compensation proposal because they felt it was the right thing to do if something were to be done. But, overall, it was not an issue for analysts to "die for."

2) *The information that results from applying a new standard should be relevant to the investment evaluation process.*

First, there is little corporate financial information that is *not* relevant to the investment process, but there is some. For example, *Financial Reporting in the 1990s and Beyond* advocates the immediate write-off of goodwill. That is because a number that reports the amount of unamortized goodwill simply is irrelevant to investment decisions. Investors look for value in those assets that generate expected future cash flows.

Goodwill, by contrast, is an asset that itself is *generated by* expectations of future cash flows. It produces nothing.

Most boilerplate included in corporate reports also is not useful. The FASB's efforts to improve disclosures relating to (1) pension and OPEB costs and liabilities, and (2) hedging and derivative positions and activities, are cases in point. Investment decisions rarely hinge on knowing that "the employer's pension plans provide retirement benefits to employees" or that an enterprise "regularly hedges against unexpected changes in commodity prices, interest rates, and foreign currency exchange rates."

3) *Certain financial information is better presented outside the audited financial statements and it should not be included in the scope of a financial accounting standard.*

Factual data are better than opinions and guesses, at least when it comes to financial accounting and reporting. The FAPC has on several occasions recommended that information be provided in the Management Discussion and Analysis (MD&A) section of the financial report and not be included in the scope of a proposed accounting standard. In many cases, it is important that financial statement users know what management's position is. That position can be presented more candidly in the MD&A than might be the case if it were subject to the codification of an accounting standard and the scrutiny of external auditors.

Therefore, the FAPC generally advocates limiting the scope of accounting standard setting. For example, although we enthusiastically supported the activities of the AICPA's Special Committee on Financial Reporting, we have disagreed with those who believe that the process of disseminating high-level operating data should be incorporated into the accounting standard-setting process.

4) *The information that results from applying a new standard should fit the double-entry accounting model, or should enhance understanding of the data contained by the model.*

It is axiomatic that information is important whether it is recognized and measured in the financial statements themselves or merely disclosed in the notes or elsewhere. Much academic research has found that this information eventually is impounded in securities prices. Therefore, why should it matter whether the data are in or out of the financial statements? In a larger sense, one might question why financial statements are needed at all.

First, financial statements save their users from a financial scavenger hunt. The maxim that "even a blind pig roots out an acorn now and then" can be turned around to say that even the most astute professional user of financial statements will occasionally miss a datum artfully hidden among the voluminous disclosures of a contemporary financial report. Furthermore, not all users are "astute professionals," and the markets operate efficiently and fairly only when the same information is available to all.

Second, investment professionals rank second only to accounting and finance academicians in their use of and reliance on databases for research. In turn, among the multitude of available financial databases, there is extraordinary diversity in the manner and degree to which they modify raw data to make it comparable across industries and between companies. Thus, it is imperative that the financial data included in financial statements be as inclusive as possible.

Third, there is the notion that "if you are going to do something, you ought to do it right." A balance sheet purports to list an enterprise's assets and liabilities; an income statement its revenues, expenses, gains and losses. Therefore, there should be good reason for omitting from those lists the accounting elements essential to them, and such omissions ought to occur only under exceptional circumstances.

5) *Economic phenomena that are similar or equivalent should be depicted as such in financial statements. That depiction ought to conform to underlying economic reality.*

This tenet embraces the FAPC's understanding of representational faithfulness. Its first manifestation is that recognition and measurement standards ought to shed light on what is real, as well as portray the substance of exchanges and other economic events accurately and completely.

Its second aspect, which goes to the heart of analysis, is comparability. Everything is relative. For example, as stated above, the FAPC first began to comment on IASC initiatives when that body first acted to implement its mandate to "harmonize" accounting standards around the world. Even though International Accounting Standards still permit a large number of alternative accounting practices, they at least set out a single benchmark standard and limit the acceptable alternatives in each pronouncement. One of the main themes of *Financial Reporting in the 1990s and Beyond* is the globalization of commerce and the financial markets. The need for comparable data to support the efficiency of markets in the international arena is immense. For that reason, the FAPC has supported strongly the FASB's international activities, including past projects such as earnings per share, and current ones such as business combinations. Our hope and expectation is that, in its international activities, we can look to the FASB also as a beacon and not a reflector.

6) *Current values usually are more useful than historic amounts, subject to reliability of their measurement.*

When *Financial Reporting in the 1990s and Beyond* was published, opinion within the FAPC and the AIMR was divided about the usefulness of fair value reporting for financial instruments. Some, but not all, of the opposition was solely on the grounds of (lack of) reliable measurement of fair value. Recent FAPC comment letters to the FASB with respect to accounting for derivatives and hedging, and to the IASC in response to its Discussion Paper on financial instruments, reveal a strong, but not unanimous, movement within the committee to support fair value. We believe that, among the larger body of AIMR members, there has been a similar movement toward acceptance of the merits of fair value measurement and recognition for financial instruments.

One of the reasons we advocate the immediate write-off of goodwill is the fact that its current value has little or no correspondence to the cost of acquiring it. Similar reasoning leads us to not want so-called "soft assets" placed on the balance sheet except when they are acquired in a purchase transaction. Even then, they should be written off or amortized quickly because their values change so quickly and extensively.

In the absence of reliable measurement, the FAPC has continually supported supplemental disclosure of current value data. We lament the disappearance of FAS No. 33, *Financial Reporting and Changing Prices*, that provided data which many of us found informative and useful despite their approximation. We attribute FAS No. 33's lack of acceptance and influence to the disappearance of high rates of inflation and the fact that many people considered it either too complex or else an imperfect vehicle for measuring the effects of inflation.

7) *Extensive disclosures usually must be required as an integral part of a new accounting standard. They are necessary: (1) to overcome the deficiencies of the mixed-attribute accounting model; and (2) to help users understand the effects*

and implications of management's accounting choices. Disclosures are not, however, a substitute for measurement and recognition.

In most FAPC comment letters, there is substantial emphasis put on disclosures. No matter how assiduously careful the FASB is to incorporate appropriate measurement and recognition, most new standards require financial statements to include additional information and explanations to make the new accounting understandable and complete. As time goes on and the Board considers topics requiring more and more complex accounting, the need for supplemental disclosure increases.

We are fated always to have a mixed-attribute accounting model. In concept, that could be avoided, but to do so would involve going to extremes. One extreme would be to count only *past* cash flows; that is, to adopt cash-basis accounting. The other would be to count only *future* cash flows; that is, to adopt economic income.[2] The first alternative would deny the value of accrual accounting; the second would substitute analysis for accounting. The two extremes are neither useful nor practicable. Therefore, the system will always fall short of perfection and there will always be a corresponding need for supplementary informative disclosures, particularly to explain and amplify the intersections where historic and current values meet. The disclosures should shed light on transactions and events with implications for an enterprise's future cash flows.

In a more practical vein, without extensive disclosures, analysts and other financial statement users would be unable to make sensible comparisons and evaluations. Analysts need to know not only the accounting method(s) chosen by management, but also the amounts and timing of its impacts on the financial statements. Accounting estimates, and their effects, also need to be disclosed. Such disclosure takes on added urgency and importance with the trend of new accounting standards to employ fewer "bright line" measurements and to place greater emphasis on economic substance.

8) *"Smoothing" and "normalization" is a function of analysis, not financial reporting.*

The AICPA Special Committee on Financial Reporting heard financial statement users say that one of their paramount activities is to seek out an enterprise's "core earnings." That search is at the heart of analysis. For its part, the Special Committee felt that accountants could divine core earnings and report them to analysts. Unfortunately, it is not that easy. In reality, core earnings is not a fact—it is an opinion. Analysts believe determining core earnings is one of the ways they add value to the process of financial analysis. (See point 3 above.)

In the second edition of their textbook, *The Analysis and Use of Financial Statements*, FAPC members Gerald I. White and Ashwinpaul C. Sondhi (and their coauthor, H. Dov Fried) discuss the analysis of restructuring. The analytical problem is to separate from the current period's income calculation those items, primarily costs, that belong to other periods. Some of them are costs of the past resulting from underdepreciation, underamortization, underaccrual or excessive deferral. Others are costs of the future which management finds expedient to treat as current expenses, thus enhancing future results and double-enhancing future rates of return. Sorting out those effects is

[2] "Economic income" would have net assets stated at the present value of future expected cash flows. Changes in net assets so-measured, other than transactions with owners, would be income. Income would be an amalgamation of the rate of interest applied to beginning net assets, plus or minus the capital value of revisions in estimates of future cash flows, variances between expected and actual cash flows for the period, and the effect of changes in interest rates. It is similar to the measurement of income for oil and gas producing enterprises under reserve-recognition accounting, or the determination of periodic pension cost if the FAS No. 87 smoothing apparatus were removed.

the business of analysis. But it cannot be done without substantial detailed accounting information of a factual nature. White et al. do an excellent job of drawing the line between the nature of analysis and the need for accounting disclosures.

The FAPC is aware that some "smoothing devices" will be found in accounting standards. Politically, certain standards could not be promulgated without them. That is why the FAPC has supported the concept of comprehensive income. It is the basis for our support of the extensive disclosures that accompany Statements of Financial Accounting Standards Nos. 87 and 106. As the legendary Detective Joe Friday used to say on the television program "Dragnet," "Just [give us] the facts, ma'am." The implication is that we'll do the analysis ourselves. But, remember, we need all the facts, not just those selected to meet some other objective.

CONCLUSION

FAPC meetings leave certain impressions. One is the frequency with which the phrase, "There shouldn't be free choice there," is heard. Financial analysts and investment managers do not like surprises, and they like being fooled even less. Accounting rules ought to be clear and they should produce the same results for the same economic transactions across a broad spectrum of events. In other words, all reporting entities ought to adhere to the same model.