

In
Focus



Transparency and Understandability, But for Whom?

How Different Standards Setters Define the 'Average User'

By Sid R. Ewer

In June 2001, Lynn Turner, then chief accountant of the SEC, gave a speech titled "The State of Financial Reporting

Today: An Unfinished Chapter III," at the

Glasser LegalWorks Third Annual SEC Disclosure and

Accounting Conference:

[In 1998 in America] there were 84 million shareholders, representing 43.6% of the country's adult population. That is a 21% increase from the number of 69.3 million just three years earlier and a 61% increase from 52.3 million in 1989.... These stockholders come from all walks of life ... half of those stockholders have income of less than \$57,000 and only 18% have family incomes that exceed \$100,000 ... the average stockholder today is the average American who lives next door ... [A]verage Americans today, more than ever before, are willing to place their hard-earned savings and trust in the U.S. capital markets ... because they have confidence in the integrity of those markets.

In less than 10 years, the number of individual shareholders had increased by more than 50%. Less than 20% of America's stockholders can be classified as high income, and how many of them possess a sophisticated knowledge of accounting matters is unclear.

Two years after Turner's speech, the Federal Accounting Standards Advisory Board (FASAB) promulgated Statement of Federal Financial Accounting Concepts 4 (SFFAC 4), "Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government." The FASAB's action had nothing to do with Turner's speech, but the underlying theme of SFFAC 4—who is the intended user of a financial report?—raises a question: Should FASB take a cue from its federal government cousin?

Whatever one thinks of the federal government's financial matters (it has never enjoyed an unqualified opinion on its financial statements), federal government accounting rule makers may have been right where SFFAC 4 is concerned. With SFFAC 4, the FASAB has signaled its intent to democratize the understandability of the U.S. government's consolidated financial report (CFR). Paragraph 6 of SFFAC 4 declares:

The CFR should be a general purpose statement of accountability to the public. A general purpose report should be easily understandable to the "average citizen" who has a reasonable understanding of Federal Government activities and is willing to study the information with reasonable diligence.

The author believes that the FASAB's conceptual approach—an understandability to average citizens—is noteworthy in how it diverges from that of FASB, the Government Accounting Standards Board (GASB) and the International Accounting Standards Board (IASB). Moreover, this article will question whether FASB and the other standards setters, perhaps without realizing it, are moving away from transparency in financial reporting through the specific words used in accounting concepts and, just as important, through the words used before in those considerations but now left out.

Characteristics of Users

FASB's Statement of Financial Accounting Concepts (SFAC) 1, "Objectives

of Financial Reporting by Business Enterprises," issued November 1978, states in paragraph 9, while discussing the environmental context of objectives, "the objectives in this Statement are affected by the economic, legal, political, and social environment in the United States." Earlier in the same paragraph, SFAC 1 notes that "objectives stem largely from the needs of those for whom the information is intended." Paragraph 24 acknowledges that "[m]any people ... are potentially interested in financial reporting," then goes on to list a multitude of potential users. Paragraphs 28–30, however, declare that the objectives of SFAC 1 are to underpin general-purpose financial statements and that the primary "focus is on information for investment and credit decisions."

Thus, FASB serves first the investor and the creditor. As for how knowledgeable that investor and creditor should be, paragraph 34 says: "The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence." In paragraph 36, however, FASB recognizes that users' "understanding of financial information ... may vary greatly," and that "financial reporting [should be able to] be used by all—nonprofessionals as well as professionals—who are willing to learn to use it properly [and that] efforts may be needed to increase the understandability of financial information."

The IASB says that its Framework for the Preparation and Presentation of Financial Statements [published in 1989 by its predecessor, the International Accounting Standards Committee (IASC)] is "concerned with general purpose financial statements [that are] directed toward a wide range of users." Paragraph 10 of the IASB Framework, however, provides that "as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy." The IASB almost mirrors FASB in its conception of the knowledge base that users possess; according to paragraph 25 of the IASB Framework, "users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with rea-

sonable diligence." The IASB thereby added "accounting" to FASB's presumed user knowledge base.

FASB's and the IASB's initial attempt to converge conceptual frameworks in their Preliminary Views placed equity investors and creditors first and second, respectively, among the seven categories of "potential users of financial reports." In the same section, paragraph OB6, the boards support general-purpose financial reporting "directed to the needs of a wide range of users rather than to the needs of a single group," noting, however, that "investors and creditors ... are the most prominent external groups who use the information provided by financial reporting. ... Thus, the primary users of general purpose financial reports are present and potential investors and creditors." The boards reiterate their support for "information that is useful to a wide range of users" (paragraph BC1.8), but say in paragraph BC1.14 that both boards still "designate investors and creditors as the primary users."

And how knowledgeable should those designated investors and creditors be? According to paragraph QC3, "[t]hose users, especially investors, may have widely differing degrees of knowledge about the business and economic environment, business activities, securities markets, and related matters" (emphasis added). Paragraph QC4 states, however, that "in developing financial reporting standards," there is a presumption that users of accounting information "will have a reasonable knowledge of business and economic activities and be able to read a financial report [and] will review and analyze the information with reasonable diligence." Furthermore, "one does not need to be an accountant or a professional investor ... but it is necessary to learn how to read a financial report." So, the IASB dropped "knowledge of accounting" from its users' presumed knowledge base, but added "able to read a financial report," and, rather than just "study," the IASB expects users to "read and analyze." FASB agreed to this description.

Turning from private-sector accounting to the public sector, GASB, in its Concepts Statement (GASBCS) 1, "Objectives of Financial Reporting," specifies in paragraph 30 the citizenry as first among three groups of primary users; investors and creditors were second and third. According to

paragraph 56: "Accountability is the cornerstone of all financial reporting in government, and ... accountability requires governments to answer to the citizenry." According to paragraph 8: "The Board takes a broad view of public accountability." Although GASB has a democratic view of the intended users of state and local government financial reports, that concept statement was published in 1987; in 2005 the GASB issued Concepts Statement 3, "Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements." Paragraph 21 of GASB 3 states that "to effectively interpret [financial reports,] the user is responsible for obtaining a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting, for studying the messages with reasonable diligence, and for applying relevant analytical skills."

GASB, which has offices in the same facility as FASB, where the two professional staffs must come into close contact, has obviously borrowed from FASB's playbook. If GASB ever intended to make financial reporting more accessible to the average citizen, paragraph 21 effectively shuts down such intentions. Indeed, GASB's intended-user model goes one better than FASB's (see the *Sidebar*). The bar appears to have been set higher for users of state and local government financial reporting than it has for readers of private-enterprise financial reports. One might speculate whether this represents some on-upmanship between the two standards setters.

FASAB Concept Statement (SFFAC) 1, "Objectives of Federal Financial Reporting," stated that the FASAB identified four user-groups of federal financial information, and it repeated those users in SFFAC 4: 1) citizens; 2) Congress; 3) executives; and 4) program managers. The FASAB categorizes citizens as an external user group and the other three groups as internal users. The recognition of citizens as an external group with little direct control over federal operations, or over the form and design of financial reporting, led the FASAB to address specifically the needs of citizens and the purpose of the U.S. government's consolidated financial report.

The FASAB promulgated SFFAC 4 because, over time, the consolidated financial report (CFR) had become complex and voluminous, and the FASAB recognized that the CFR was trying to serve too many masters. Currently, the report encompasses more than 100 pages. The FASAB decided to determine the primary users of the CFR in order to rein in some of the CFR's more unwieldy features. In determining specifics of federal financial information to provide the citizen user, the FASAB followed the advice of the Association of Government Accountants' 1994 study "Toward a Report to Citizens on the State of Their Nation and the Performance of Their Government." That study promoted a succinct yet comprehensive picture of the U.S. government's activities. Accordingly, the challenge would be to make the CFR succinct while still addressing all four objectives outlined in SFFAC 1: 1) budgetary integrity; 2) operating performance; 3) stewardship; and 4) systems and control. The FASAB acknowledged that the CFR would not satisfy all four objectives for all audiences, and internal-user groups would need to rely on more-detailed reports. The FASAB thinks, however, that users other than citizens are often likely to employ the CFR as merely a starting point in acquiring more financial information.

Distinctions Between the Standards Setters

The four standards-setting boards' understandings of the external user's sophistication in financial reporting usage appear imperceptibly different, yet examining how each board describes its constituents' characteristics reveals significant distinctions. FASB, in paragraph 34 of SFAC 1, states that "[financial] information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence." The FASAB acknowledges that it bases its definition of a general user on FASB's definition in SFAC 1; paragraph 6 of SFFAC 4 as noted above, declares:

The CFR should be a general purpose statement of accountability to the public. A general purpose report should be easily understandable to the "average citizen" who has a reasonable understand-

ing of Federal Government activities and is willing to study the information with reasonable diligence.

The words "easily" or "average citizen" do not appear in FASB's definition of the abilities of the external user. Moreover, FASB notes that the primary external user is one who is interested in investment and credit decisions. Although FASB is inclusive in its notions of those interested in investment and credit decisions, the ensuing discussion of them implies a level of cognizance in financial reporting topics that exceeds the typical

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vision of the "average citizen." The IASB echoes FASB in targeting investors and creditors first, although the IASB uses the words "wide range of users," which FASB did not use until 2006, in the Preliminary Views. But absent from FASB's Preliminary Views are the SFAC 1 words "understanding of financial information," "may vary greatly," and "efforts may be needed to increase the understandability of financial information."

Both GASB and the FASAB designate citizens as the primary user group

of financial reporting. GASB, however, demands more financial analysis acumen from its users than does the FASAB. GASB has actually ratcheted up its expectations of users over those expected of business accounting standards setters. The *Exhibit*, which compares key terms of each of the boards' notions of user characteristics and the year such characteristics were published, indicates a trend of rising expectations of users. After 1978, except for the FASAB, each board added to "understanding of ... and willing to study ... with diligence" words that required additional competencies or efforts from users.

Understandability

In its SFAC 2, "Qualitative Characteristics of Accounting Information," issued in 1980, FASB asserted (paragraph 40) that "understandability of information is governed by a combination of user characteristics and characteristics inherent in the information." Paragraph 41 states:

Understandability and similar qualities of information ... are closely related to the characteristics of *particular* decision makers as well as *classes* of decision makers ... The Board establishes concepts and standards for general purpose external financial reporting by considering the needs of broad classes of decision makers and cannot base its decisions on the specific circumstances of individual decision makers. [emphasis added]

In the hierarchy of qualitative characteristics accounting information (SFFAC 2, Table 1), FASB declared that all characteristics must meet the test of understandability before they can be useful information for making decisions.

Paragraph 25 of the IASB Framework defines understandability at the same time and with the same sentence it uses to address user characteristics: "[U]sers are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence." Thus, the IASB couches understandability of accounting information in terms of presumptive users with a certain level of knowledge in, and willingness to study, accounting information. This may appear only superficially different from the intent

of FASB in SFAC 2, but SFAC 2, paragraph 41, declared: "The Board establishes concepts and standards for general purpose external financial reporting by considering the needs of *broad classes* of decision makers" (emphasis added). Note FASB's use of the plural "classes," presumably meaning more than just the investor and creditor classes.

However, in the Preliminary Views, paragraph QC39, both FASB and the IASB explain succinctly that understandability can be accomplished only by presumptions of a user's knowledge and willingness: "[U]nderstandability is the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial reporting, and who study the information with reasonable diligence, to comprehend its meaning." FASB and the IASB (paragraph BC2.39) concluded that "the framework needed to clarify both the qualitative characteristic of understandability and the characteristics and responsibilities of users of financial reports ... by incorporating into the definition of understandability the responsibility of users to study information with reasonable diligence rather than only being willing to do so."

The boards also rejected displaying a chart similar to SFAC 2's chart of "A Hierarchy of Accounting Qualities." That chart positioned "understandability" as the focal point through which all other accounting-quality descriptors must pass. According to FASB and the IASB in the Preliminary Views, paragraph BC2.61: "To include such a chart in a chapter focusing solely on qualitative characteristics would be premature."

In GASBCS 1 (paragraph 63), GASB gave its position on understandability:

Information in financial reports should be expressed as simply as possible. Users ... tend to have different levels of knowledge and sophistication about governmental accounting and finance. To be publicly accountable, a government should issue financial reports that can be understood by those who may not have a detailed knowledge of accounting principles. Those reports should include explanations and interpretations that help users understand the information provided.

This was almost 20 years ago. In 2005, GASBCS 3, paragraph 21, made users "responsible for obtaining a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting, for studying the messages with reasonable diligence, and for applying relevant analytical skills."

The FASAB's Framework, paragraph 15, notes that citizens "may not have the knowledge or desire to take the time to understand more sophisticated reports [and thus the FASAB] should focus on meeting the basic needs of citizens for highly summarized information." Beyond this highly summarized information, the FASAB emphasized the ability of individual user groups to easily find more detail if they desire it. GASB seems to have abandoned its notions of accountability to the citizenry—except for those citizens who can apply relevant analytical skills. The FASAB still keeps words of democratization that GASB has discarded.

COMPARISON OF USER MODELS

GASB

- Reasonable understanding of government and public financing and of the fundamentals of government financial reporting.
- For studying the messages with reasonable diligence.
- For applying relevant analytic skills.

FASB

- Reasonable understanding of business and economic activities.
- Willing to study the information with reasonable diligence.

Has FASB forsaken the words “efforts may be needed to increase the understandability of financial information”? Even more important is whether FASB has abandoned the idea expressed in 1978 with SFAC 1, paragraph 9: “[T]he objectives in this Statement are affected by the economic, legal, political, and social environment in the United States ... [and] ... objectives stem largely from the needs of those for whom the information is intended.”

Current Contexts

Environmental contexts change, and while many users of financial information today possess similar cognizant characteristics envisioned by FASB almost 30 years ago when it issued Concept Statement 1, many capital-market participants are a different breed of investor. The accounting profession ignores at its peril, or at least its discomfort, the fact that, in the current political and social environment, investors in the capital markets today are a more varied bunch than capital-market participants 30 years ago.

FASB consistently recognizes changes in the economic and legal contexts of the reporting environment and strives to force

transparency into complex accounting matters. To quote Lynn Turner further: “[A]lmost all of the financial instruments used today had not been created [years earlier]” and “special purpose entities [SPE] ... have been specifically designed ... to reduce transparency to investors.” The profession seems willing to handle the increasing complexity of technical accounting matters, but does it address adequately the changing demographics of users of financial information, or, perhaps more appropriately put, of potential users of financial information if such information were made more transparent to a democratized capital marketplace?

Whether federal financial managers will be able to structure the CFR to make it meaningful yet understandable to the average citizen remains to be seen. Concurrently with SFFAC 4, FASAB issued Statement of Federal Financial Accounting Standards (SFFAS) 24, “Selected Standards for the Consolidated Financial Report of the United States Government.” SFFAS 24, paragraph 8, notes that “SFFASs apply to all federal entities ... as a whole and to component units” (“component units” refer to indi-

vidual federal agencies and departments), unless an SFFAS eliminates a provision. SFFAS 24 eliminated for consolidated financial reporting certain information required of component unit financial reporting, but instituted two other reporting requirements specific to consolidated financial reporting:

- A financial statement that reconciles net operating revenues/costs with the annual unified budget surplus; and

- A financial statement that reconciles the annual unified budget surplus or deficit to the change in the government’s cash.

The appendices to SFFAS 24 illustrate these two statements using line-item descriptions such as “components of net operating revenue not part of the budget surplus.” The FASAB acknowledged that even the phrase “budget surplus” could be misleading to the average reader, but also declared, in paragraph 27, that these statements were designed with SFFAC 4 and the needs of the average citizen in mind. The FASAB also acknowledged that bringing additional clarity to the consolidated financial statement would be an ongoing matter.

A Laudable Goal

The FASAB venture, although difficult, is laudable. Just as actual and potential investors and creditors are stakeholders in a business enterprise, citizens are the stakeholders in government activities. Democratizing financial communication to the citizen stakeholder is a goal worth pursuing.

FASB might take more than a passing notice of the FASAB’s efforts. The profession that FASB serves seems to believe that, for the most part, its public-interest responsibilities begin and end with helping to ensure effective capital markets. The recent problems in the capital markets, however, were caused, or at least exacerbated, in no small measure by the unprecedented numbers of novices—“average citizens”—participating in a booming capital market. Had these novice investors had a better handle on financial reporting matters, perhaps some of the problems would have been avoided. □

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EXHIBIT

Key Terms Used to Characterize Users of Financial Information

Standard Setter	Year Issued	User Focus	Characteristics Referred to or Described in the Literature
FASB	1978	Investors and creditors	Understanding of business and economic ... willing to study ... with ... diligence
IASB	1989	Investors and creditors	Understanding of business and economic and accounting ... willing to study ... with ... diligence
FASB and IASB	2006	Investors and creditors	Knowledge of business and economic activities ... able to read a financial report ... will review and analyze ... with ... diligence
GASB	2005	Citizenry	Understanding of government and public finance ... and ... fundamentals of governmental financial reporting ... study ... with ... diligence, and ... apply relevant analytical skills
FASAB	2003	Average citizen	Easily understandable to the “average citizen” ... understanding of Federal Government activities ... willing to study ... with ... diligence