Will you adopt quality financial reporting?
Miller, Paul B W
Strategic Finance; Jan 2001; 82, 7; ProQuest Central
pg. 50

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

WILL YOU ADOPT Quality Financial Reporting?

FINANCIAL PROFESSIONALS, IT'S TIME TO GIVE THE PUBLIC AS MUCH ACCURATE FINANCIAL INFORMATION AS YOU CAN.

BY PAUL B.W. MILLER, CPA

When you select a financial reporting strategy, you're making a safe bet if you follow in Warren Buffett's footsteps. Consider these thoughts from his 1996 "Owner's Manual" for Berkshire-Hathaway's stockholders:

At Berkshire you will find no "big bath" accounting maneuvers or restructurings nor any "smoothing" of quarterly or annual results. We will always tell you how many strokes we have taken on each hole and never play around with the scorecard. When the numbers are a very rough "guesstimate," as they necessarily must be in insurance reserving, we will try to be both consistent and conservative in our approach.

So, if your company is presently "playing around with the scorecard," you should consider embracing a Quality Financial Reporting (QFR) strategy and start presenting as much useful public information as possible. This approach promises lower capital costs and higher security prices because it's more than likely that the capital markets respond to inadequate reporting by bidding stock prices down—not up.

ILLUSTRATIONS: KEN ORVIDAS

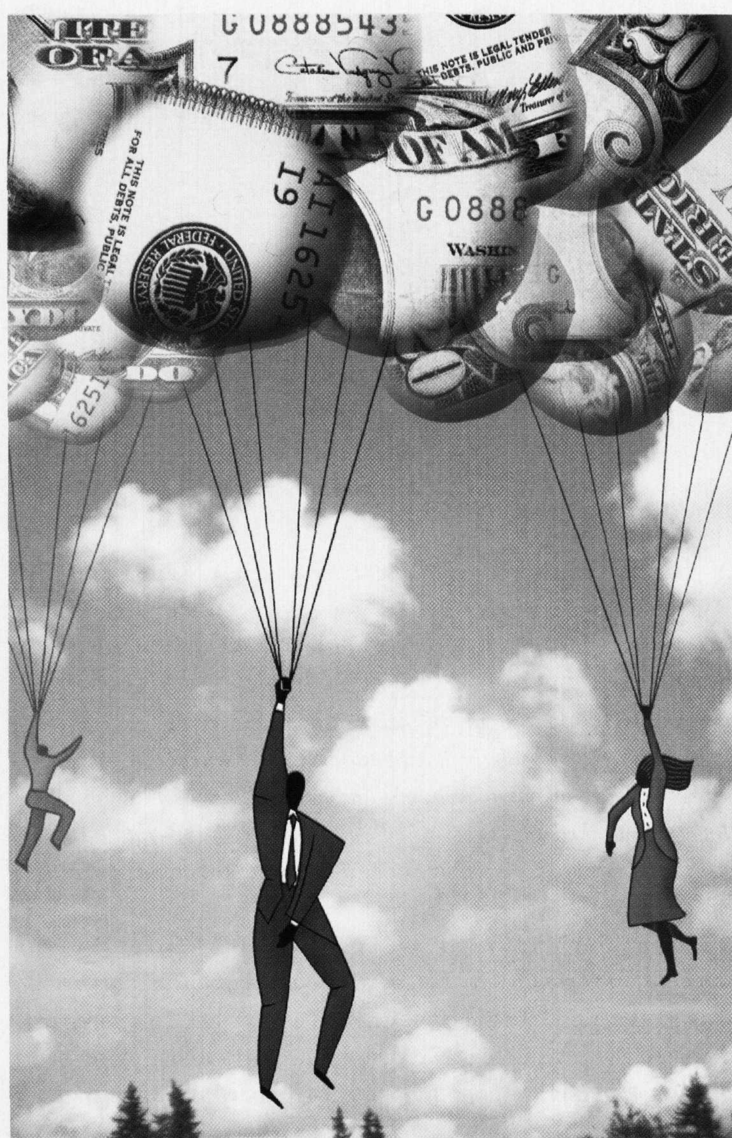
Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

When you adopt QFR, you will likewise try to build better relationships with the capital markets by providing the best financial statements you can.

THE TRADITIONAL REPORTING MODEL

Traditional reporting strategies have been conceived and implemented in concert with the naive assumption that capital markets depend totally on managers to provide public information for their use. Unfortunately, analysts aren't getting the information they need because generally accepted accounting principles (GAAP) emerge from a political process that's too contentious and compromised to deliver the useful information that the markets need.

How did we get to this point? The last 10 to 20 years have seen significant controversies over many reporting issues. The list is long, including changing prices, foreign currency translation, pensions, consolidations, the statement of cash flows, income taxes, medical benefits, investments in securities, stock-based compensation, derivatives, and business combinations. In all these cases and others, managers (often spurred on by their auditors) vehemently resisted efforts by the Financial Accounting Standards Board (FASB) to initiate new requirements. The ultimate result of the political pressure is severely compromised standards that are far short of optimal for informing the markets.



If the standards aren't optimal, then you probably have significant opportunities for improvement. What you should've learned from Total Quality Management (TQM) is that being the best at any point in time isn't a reason to relax; rather, the goals are to build good customer relationships and to keep working toward being as good as possible. When you adopt QFR, you will likewise try to build better relationships with the capital markets by providing the best financial statements you can. Thus, the strategy of minimum compliance with GAAP is terribly shortsighted. Nonetheless, that's all that today's managers try to do. In fact, they treat these obviously weak standards as maximums instead of minimums and don't fully inform the capital markets. In that sense, financial reporting is like the rest of the world was before TQM and customer orientation came to light as superior strategies.

SOLVING THE PROBLEM

Capital markets have needs and desires for financial information that aren't addressed by

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

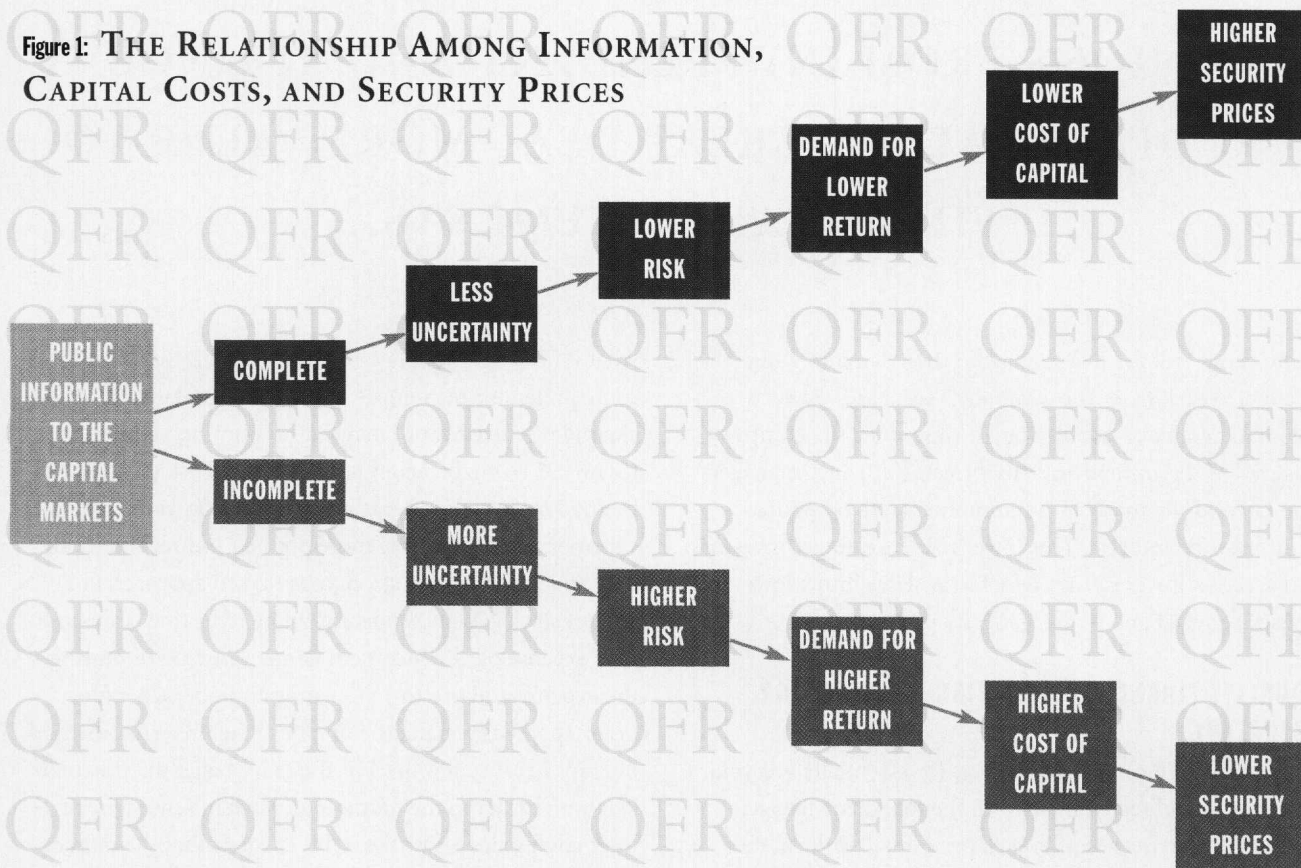


Figure 1: The Relationship Among Information, Capital Costs, and Security Prices

traditional public reports. Professors Marc Epstein and Krishna Palepu uncovered numerous shortcomings in current financial statements when they surveyed a group of leading financial analysts, as reported in the April 1999 issue of *Strategic Finance* ("What Financial Analysts Want"). According to their research, the balance sheet is "often perceived as irrelevant because of its reliance on historical costs and arbitrary write-offs of intangible assets" and that "footnotes seem to frustrate analysts the most" because they didn't understand them or because they don't contain adequate information.

Their findings confirm that complying with GAAP doesn't provide enough information to satisfy the markets. So what? Three outcomes are possible, and they're all negative.

First, the lack of useful information in a company's financial statements may cause the markets to pursue other investment opportunities. If so, the resulting diminished demand for its securities creates lower prices and higher capital costs. This doesn't exactly increase shareholder value.

Second, the markets may decide that the company's investment potential is great, even though the reported information is inadequate. If so, they may invest, but only after taking into consideration the resulting high degree of uncertainty and insisting on a higher expected rate of return that will depress the securities' prices and increase the cost of capital. Again, this typical minimum reporting strategy doesn't advance the stockholders' interests.

Third, sophisticated investors and creditors will turn elsewhere for private information that's more useful than GAAP financial statements. Common sense and a lot of research confirm that market participants are highly motivated to discover information that no one else knows and that they are successful at finding it.

In contrast, if managers were to provide additional—and useful—public information, less uncertainty would exist, the analysts' extra efforts and the redundant costs of finding that information would be avoided, and the information would be more reliable simply because it would come from primary sources. Managers could also increase the information's credibility by submitting it to attestation. In all likelihood, this voluntary flow of credible public information would increase demand for the company's securities, create higher prices for them, and reduce capital costs.

Figure 1 describes the economic forces that drive this phenomenon. Incomplete information fosters uncertainty about the real situation facing the company as well as management's trustworthiness. The uncertainty translates

المنارة للاستشارات
Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

> OPINIONS FROM INDEPENDENT AND STRINGENT AUDITORS ADD A GREAT DEAL MORE VALUE TO FINANCIAL STATEMENTS...

into more risk for investors, who then demand a higher rate of return from the company's securities. In turn, this demand creates a higher cost of capital for the company, as well as discounted security prices. But when managers go beyond the minimum requirements, they reduce uncertainty and risk. This lower risk encourages investors to accept a lower return, which translates into a lower cost of capital and higher security prices.

QUALITY FINANCIAL REPORTING—A SUPERIOR STRATEGY

Adopting QFR has positive effects for essentially everyone directly or indirectly involved in the markets. Managers benefit by having access to cheaper capital. In turn, they can earn more income and enjoy payoffs from appreciated stock options and other incentives. Stockholders also benefit from greater demand for their shares and a rate of return that's appropriate for their real risk. All investors and creditors are better off because they can evaluate investment opportunities with more emphasis on their financial merits and less concern for risk created by incomplete information. The economy operates more productively because the capital markets can establish security prices more efficiently. Ultimately, society as a whole reaps many benefits from that increased productivity.

Undoubtedly, two groups will lose when QFR is practiced. The first includes those who have somehow fooled the markets. In light of the markets' ability to penetrate ruses and penalize the perpetrators with discounted stock prices, it seems unlikely that this group is very large, if it exists at all. The second group consists of those who successfully cheat the markets with illegal insider information. Because QFR puts additional information more quickly and reliably into the capital markets, their advantages would diminish, and it makes no sense to shed any tears over them, does it?

THE HIGH ROAD

How would someone—financial professionals—get started on QFR? One safe way is to take the high road by doing what the FASB has *recommended* instead of merely doing what it has *permitted*. The Board has already identified some preferable techniques that aren't mandatory. For example, Statement of Financial Accounting Standards (SFAS) 95 strongly recommends that you use the direct method to describe operating cash flows on your cash flow statements instead of the more popular indirect method. You can also apply the strongly preferred approach in SFAS 123 on stock-based compensation by reporting compensation expense on the income statement instead of putting the expense and pro forma earnings numbers in a footnote. Apparently managers don't use the preferred method, perhaps because they harbor the naive belief that the markets won't react to the footnote in assessing the value of their companies' securities. QFR suggests that the markets actually penalize stockholders with lower security prices even though management reports larger earnings on the income statement. Still another step on the high road is to stay away from pooling.

A second avenue is to engage tough auditors and do what they say instead of picking cheap and easy auditors who do what you say. Opinions from independent and stringent auditors add a great deal more value to financial statements than those issued by auditors who are known to have (or are even thought to have) compromised independence. It doesn't do stockholders (or managers) any good to publish high and smooth earnings and a low debt/equity ratio if no one trusts the auditors.

Yet a third avenue is to branch out into new areas based on your own market research and common sense as to what helps statement readers make better decisions. One area ripe for innovation is expanded use of market values in reporting assets, liabilities, and income. The standard-setting process has been reluctant to introduce values in the financial statements, especially if doing so means displacing historical costs. An Association for Investment Management and Research (AIMR) position paper ("Financial reporting in the 1990's") illustrates that sophisticated investors have a strong demand for market values when it says, "There is no financial analyst who would not want to know the market value of individual assets and liabilities."

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

users of (1) minimizing the cost of providing the data by having the firm do it once and provide it to multitudes of users who otherwise would individually have to replicate the firm's effort; (2) having the firm as the source of information thus obviating the need for analysts to scavenge for less reliable data from secondary sources; and (3) making available an additional source of information that confirms or denies other sources.*

In light of these factors, resisting QFR because of preparation costs seems to be very shortsighted.

AN OBJECTION

At this point, you might object to QFR because of higher preparation costs created by additional reporting and auditing efforts. Look at it this way: You and your stockholders will realize large rewards from a lower cost of capital, more real income, and higher security prices.

Overcoming this objection may be complicated because most CFOs have budgets that consider only out-of-pocket costs without factoring in these huge returns from lower capital costs. So try thinking of the reporting function as a profit center instead of a cost center. QFR also suggests that shareholders will gladly bear the brunt of the higher preparation costs in order to receive the benefits of fully informed markets. The same AIMR paper describes analysts' thoughts on this cost issue:

In particular, it is the providers of financial statements from whom the claim of excessive cost is heard. We can respond by asserting that the cost to them, high as it may seem, is still less than the benefit to financial statement users of (1) minimizing the cost of providing the data by having the firm do it once and provide it to multitudes of users who otherwise would individually have to replicate the firm's effort; (2) having the firm as the source of information thus obviating the need for analysts to scavenge for less reliable data from secondary sources; and (3) making available an additional source of information that confirms or denies other sources.

ARE YOU READY?

This comment talks about the ideas behind Quality Financial Reporting:

Permanent improvement in accounting practices and in methods of corporate reporting cannot be brought about by legislation or by government regulation. The regulations laid down by a governmental bureau serve a good purpose but can never successfully take the place of individual initiative, intelligence, and courage. If any real progress is to be made towards continued improvement in corporate reporting, it must flow from the efforts of those charged with the direct responsibility of determining the policies of corporations. As professional accountants, we can contribute to this progress by emphasizing the advantages of adhering to sound business principles, by seeking to establish more firmly the standards for accounting practice, and by having the moral courage to cling to these standards.

What ought to be embarrassing to us all is that these words were spoken by Arthur Andersen way back in 1935. There should be no doubt that the time to improve the quality of your financial reporting policies has come. Are you ready? ■

Paul B. W. Miller, CPA, Ph.D., professor of accounting at the University of Colorado at Colorado Springs, has been a professional staff member at both the Financial Accounting Standards Board and the Securities & Exchange Commission. He is an author of more than 15 books and numerous articles with a focus on the effect of politics on GAAP. He has also written a regular lead column for Accounting Today *since 1996.*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com